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Twenty-Three Potential Compliance Pitfalls in the SEC's New Private Fund Rules

The U.S. Securities and Exchange Commission (SEC) adopted new rules and amendments[1] that will dramatically increase the regulatory obligations of private fund advisers and will likely exacerbate enforcement and examination risk. As detailed below, many of the new rules codify and bolster recent enforcement and examination trends, as well as areas that the SEC has historically targeted. Kroll summarized the SEC's over 600-page release of the final rule, and, after further digesting the rule, Kroll's compliance experts have identified 23 potential compliance pitfalls that the SEC's Division of Examinations and Division of Enforcement Staff (collectively, the "SEC Staff") will likely scrutinize.

Advisors can seek, avoid and address these pitfalls in the coming months to mitigate the enforcement and examination scrutiny that will likely result. The SEC reported that in 2023, 18% of its enforcement actions involved investment advisers or investment companies. The agency continues to devote significant amounts of its examination and enforcement staffing resources to policing the space, and its officials have been publicly stating their expectations that organizations will adopt a culture of "proactive" compliance. There is a high likelihood that the adoption of the new private fund rules will lead to increased compliance requirements for private funds and alter the economics of performing investment advisory services. With the final

[1] Several private fund associations have already challenged the SEC's rulemaking in a petition for review filed in the United States Court of Appeals for the Fifth Circuit. https://www.managedfunds.org/wp-content/uploads/2023/09/MFA-Filing.pdf.

implementation date varying from between 60 days[2] (i.e., November 13, 2023) and 18 months after the rules were published in the Federal Register (which occurred on September 14, 2023), advisers should have already begun the process of analyzing the rules and developing the required enhancements and changes to their compliance programs. As the SEC recently demonstrated with its first Marketing Rule enforcement action, Kroll's experts believe that there is a high likelihood that the SEC will deploy a strategy of examining and enforcing for compliance with newly-enacted provisions in order to assess compliance with the agency's mandates.

Pitfall 1: Preferential Treatment

Perhaps the thorniest new rule to interpret is the Preferential Treatment Rule, which bars offering certain redemption rights and information to investors in a fund unless they are offered to all investors in the fund, as well as requires disclosure of other preferential treatment.[3] "Preferential treatment" is not a defined term in the new rules. However, the SEC clarified that the rule covers informal communications like phone conversations where preferential information is shared, as well as preferential terms in formal side letters, governing documents, or other investor agreements.[4] This rule expands upon issues targeted by the SEC, which has listed preferential liquidity rights as a common exam deficiency[5] and brought several enforcement cases involving preferential information and redemptions.[6]

Pitfall 2: Preferential Treatment—Reasonably Expects and Material, Negative Effect

The Preferential Treatment Rule restricts offering investors redemption rights or information about the fund that the "adviser reasonably expects" would have a "material, negative effect on other investors in that private fund or in a similar pool of assets."[7] Commenters raised concerns that adviser decisions will be judged in hindsight, to which the SEC responded that it adopted "an objective standard that takes into account what the adviser reasonably expected at the time."[8] Lots of ink has been spilled and many legal bills have been incurred on the subjects of reasonable expectations and materiality.[9] Likewise, the rule does not define "negative," which can have a broad scope. The undefined terms in this new standard are ripe for interpretation and likely to attract the SEC Staff's focus in exams and enforcement.

Pitfall 3: Preferential Treatment—Offer Information at Substantially the Same Time

The exception for an adviser providing—to any investor in the fund—information that would have a material, negative effect on other investors, requires the adviser to "offer such information to all existing investors in the private fund and any similar pool of assets at the same time or substantially the same time."[10] The SEC is worried that a preferred investor could use information to front-run other investors.[11] The SEC clarified that

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[2] The compliance date for the amended rule requiring annual reviews to be documented in writing is only 60 days after the rules are published in the federal register. See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-6383, (August 23, 2023) at 314–15, https://www.sec.gov/files/rules/final/2023/ia-6383.pdf (hereinafter "Adopting Release"); 17 CFR § 275.206(4)-7. All references to the Code of Federal Regulations are to the newly adopted rules, unless prefaced by "Existing Rule."

[3] 17 CFR § 275.211(h)(2)-3.

[4] Adopting Release at 282–83.

[5] See https://www.sec.gov/ocie/announcement/risk-alert-private-funds

[6] See, e.g., https://www.sec.gov/files/litigation/admin/2018/ia-4991.pdf; https://www.sec.gov/news/press-release/2013-159; https://www.sec.gov/litigation/litreleases/lr-19427; *see also* Adopting Release at 268–69 n. 797.

[7] 17 CFR § 275.211(h)(2)-3(a).

[8] Adopting Release at 271–72.

[9] See, e.g., https://corpgov.law.harvard.edu/2021/05/01/corporate-governance-update-materiality-in-america-and-abroad/.

[10] 17 CFR § 275.211(h)(2)-3(a)(2).

[11] Adopting Release at 265.

"this exception should allow advisers to discuss their portfolio holdings during investor meetings so long as all investors have access to the same information" and that to "qualify for the exception, the adviser must offer to provide the information to other investors."[12] But these statements use conflicting language, making it unclear whether the information has to be proactively shared (such as in direct communication containing the information), offered to be provided, or simply accessible to other investors (like when it's placed on an investor portal with notice). The SEC Staff has been on the alert for front-running schemes with several recent enforcement actions and is likely to continue to closely monitor this area.[13]

Pitfall 4: Preferential Treatment—Similar Pool of Assets

The restrictions on certain offerings of redemption rights and information relate to investors in a private fund or a "similar pool of assets."[14] The determination of whether a pool of assets is "similar" will require "a facts and circumstances analysis," but the term is "designed to capture most commonly used private fund structures . . . and prevent advisers from structuring around the prohibitions on preferential treatment."[15] The SEC Staff is likely to examine for potential structuring around the rule.

Pitfall 5: Preferential Treatment—Disclosure Generally

The Preferential Treatment Rule also mandates that an adviser to a private fund distribute disclosures related to any preferential treatment the adviser or a related person provides to any investor in the fund.[16] The rule identifies three situations that trigger these disclosures. In summary, they are:

a. For prospective investors, a summary of any preferential "material economic terms" provided to other investors in the fund[17];

b. For current investors, all preferential treatment provided to other investors in the fund:

    i. for illiquid funds, at the conclusion of the fundraising period,

    ii. for liquid funds, following the investor's investment[18];

c. For current investors, an annual notice of new preferential treatment, if any.[19]

The rule does not grant legacy exemptions for these disclosures. This means that preferential treatment provided prior to the rule's compliance date needs to be disclosed when a notice is triggered.[20] The SEC Staff is apt to closely monitor these disclosures as new rules requiring notices to investors often lead to notice-related exam deficiencies.[21]

Pitfall 6: Preferential Treatment—Fundraising through the Compliance Date

The Preferential Treatment Rule is not clear about how funds should approach the transition as these new rules go into effect. A fund with investors that continues to fundraise after the compliance date will need to disclose to prospective investors the

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[12] Adopting Release at 263, 284.

[13] See, e.g., https://www.sec.gov/news/press-release/2022-228; https://www.sec.gov/news/press-release/2021-118; https://www.sec.gov/news/press-release/2021-186.

[14] 17 CFR § 275.211(h)(2)-3.

[15] Adopting Release at 286–88.

[16] 17 CFR § 275.211(h)(2)-3(b).

[17] 17 CFR § 275.211(h)(2)-3(b)(1).

[18] 17 CFR § 275.211(h)(2)-3(b)(2)(i) & (ii).

[19] 17 CFR § 275.211(h)(2)-3(b)(2)(iii).

[20] 17 CFR § 275.211(h)(2)-3(d); Adopting Release at 317.

[21] See, e.g., https://www.sec.gov/ocie/announcement/ocie-risk-alert-regulation-s-p at 2–3.

preferential material economic terms that it gave to any investor. However, this information was not required to be provided to those that invested prior to the compliance date. This could set up the very type of information asymmetry that concerns the SEC Staff.[22]

Pitfall 7: Preferential Treatment—Funds No Longer Fundraising

The rule similarly lacks clarity for funds no longer accepting new investors. Private funds not admitting new investors, or providing new preferential terms to existing investors, do not need to deliver the annual notice.[23] The rule's remaining disclosure provisions are triggered by an investment or the conclusion of a fundraising period, but it is an open question whether they apply to funds that closed all of their investments or fundraising prior to the compliance date.

Pitfall 8: Restricted Activities—Fair and Equitable

The Restricted Activities Rule includes a restriction on advisers charging or allocating fees or expenses on a non-pro rata basis unless the fees are "fair and equitable under the circumstances" and the adviser discloses "a description of how [the allocation] is fair and equitable under the circumstances."[24] The SEC did not attempt to define "fair and equitable," rather it noted the determination "will depend on factors relevant for the specific expense."[25] The SEC also explained that it intends this rule to "encourage advisers, as fiduciaries, to review their approach to allocating fees and expenses to their clients."[26] This rule continues a trend in which the SEC Staff has put out risk alerts and brought enforcement actions to emphasize advisers' fiduciary duties related to accuracy of fee calculations and disclosures.[27]

Pitfall 9: Restricted Activities—Adviser Borrowing

The Restricted Activities Rule also requires disclosure and consent when an adviser borrows from a private fund client. The disclosure must contain the "material terms" of the borrowing,[28] however the SEC did not specify the terms that must be disclosed, which will depend "on the facts and circumstances."[29] The SEC Staff has brought, and will likely continue to bring, enforcement actions where adviser borrowing is not properly disclosed and consented to and the Staff will likely pay close attention to this facts and circumstances analysis in enforcing this rule.[30]

Pitfall 10: Restricted Activities—Consent

Two of the Restricted Activity Rules contain exceptions if the adviser obtains advance consent from a majority of investors that are not related persons of the adviser.[31] The SEC explained that limited partner advisory committee's (LPAC) are an insufficient consent mechanism because they "may not have sufficient independence, authority, or accountability to effectively oversee and consent to conflicts or other harmful practices."[32] The SEC's commentary also calls into question the use of LPACs more broadly to address conflicts in existing

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[22] See Adopting Release at 265–66.

[23] Adopting Release at 298 n. 893.

[24] 17 CFR § 275.211(h)(2)-1(4).

[25] Adopting Release at 231.

[26] Adopting Release at 233.

[27] See, e.g., https://www.sec.gov/files/exams-risk-alert-fee-calculations.pdf; https://www.sec.gov/news/press-release/2022-107.

[28] 17 CFR § 275.211(h)(2)-1(5).

[29] Adopting Release at 247.

[30] See, e.g., https://www.sec.gov/files/litigation/admin/2017/ia-4721.pdf; https://www.sec.gov/files/litigation/admin/2020/ia-5490.pdf.

[31] Adopting Release at 209.

[32] Adopting Release at 208.

funds and signals that the SEC Staff may be focused on the use of LPACs to approve adviser conflicts of interest. The SEC has previously listed as common exam deficiency the failure to seek timely consent from an LPAC and to provide an LPAC with complete information, which will likely continue to be a focus.[33]

Pitfall 11: Unregistered and Offshore Private Fund Advisers

The Restricted Activities and Preferential Treatment Rules apply to registered and unregistered private fund advisers, alike. However, these rules do not apply to offshore fund clients of registered offshore advisers and unregistered offshore advisers, regardless of whether the funds have U.S. investors.[34] The SEC has brought enforcement cases against unregistered advisers and will continue to do so under these rules.[35]

Pitfall 12: Adviser-Led Secondaries

Moving to the Adviser-Led Secondaries Rule, it defines "adviser-led" as "initiated by the investment adviser or any of its related parties."[36] Whether a secondary transaction is adviser-led "requires a facts and circumstances analysis" but would generally not include an adviser assisting in a secondary sale "at the unsolicited request of the investor."[37] These facts and circumstances analyses are ripe for SEC Staff scrutiny.

Pitfall 13: Adviser-Led Secondaries—Independent Opinion Provider

Registered advisers conducting an adviser-led secondary transaction are required to:

a) Obtain and distribute to investors either a fairness opinion or a valuation opinion from an independent opinion provider.

b) Distribute a "summary of any material business relationships" between the independent opinion provider and the adviser or related persons for the prior two-year period.[38]

Determining the materiality of the business relationship "requires a facts and circumstances analysis," which is typically met by auditing, consulting, and investment banking, among other services.[39] These facts and circumstances analyses will be ripe for SEC examination and enforcement actions, in-line with historical SEC enforcement practices over valuation disclosures.[40]

Pitfall 14: Annual Review Applicable to All Registered Investment Advisers

While the vast majority of the new rules and regulations are directed at advisers to private funds, the SEC has imposed a mandate that all registered investment advisers document, in writing, their required annual reviews of their firm's compliance program.[41] An improperly designed, conducted or documented review could create compliance exposure through being either underinclusive or overinclusive: the review could fail to identify and test specific risks, or the review could be insufficiently tailored or improperly supported, respectively. The SEC has already focused on inadequate annual reviews as a common deficiency and will continue to do so.[42] Kroll's experts believes that this area is one of the "low-hanging fruits" that will receive attention from the SEC's examination teams in the early post-implementation phase.

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[33] See https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf at 2–3.

[34] Adopting Release at 48–50.

[35] See, e.g., https://www.sec.gov/files/litigation/admin/2022/ia-6121.pdf; https://www.sec.gov/files/litigation/admin/2017/ia-4800.pdf.

[36] 17 CFR § § 275.211(h)(1)-1.

[37] Adopting Release at 192.

[38] 17 CFR § 275.211(h)(2)-2.

[39] Adopting Release at 202.

[40] See, e.g., https://www.sec.gov/news/press-release/2016-174.

[41] 17 CFR § 275.206(4)-7.

[42] See https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf at 2.

Pitfall 15: Quarterly Statements—Valuations

The new rules require registered private fund advisers to distribute quarterly statements to investors.[43] The SEC intends for the quarterly statements to provide investors with more context for analyzing advisers' valuations. The quarterly statements for illiquid funds, for example, are required to include a gross multiple of invested capital for realized and unrealized investments. This will allow investors to better compare the actual distributions received on realized investments with the adviser's valuations of the unrealized portfolio to determine whether it is inflated.[44] The SEC appears to be signaling a focus on inflated valuations, continuing a trend from recent enforcement actions and exam deficiencies.[45]

Pitfall 16: Quarterly Statements—Marketing

In some circumstances, the quarterly statements will need to be harmonized with the Marketing Rule.[46] For example, if a quarterly statement includes information about new or additional investment advisory services it may be subject to compliance obligations of the Marketing Rule.[47] The SEC Staff has begun enforcing Marketing Rule violations in earnest and will likely scrutinize these statements for infringing advertisements.[48]

Pitfall 17: Quarterly Statements—Liquid vs. Illiquid

The quarterly statements are required to contain different content depending on the adviser's determination that a fund is "liquid" or "illiquid."[49] The rule reduces this determination to two factors: (1) whether a fund is required to redeem interests upon an investor's request; and (2) whether investors have limited opportunities to withdraw their investment.[50] The SEC Staff will likely test these determinations and has previously brought enforcement actions for improper liquidity classifications.[51]

Pitfall 18: Investor Reporting

The requirement to issue (unaudited) quarterly statements will likely increase costs and require investment in systems and personnel to collect and report client and investor information. The frequency of such reporting, coupled with shortened timeframes for collating and analyzing reportable data, increases the risks of calculation errors. This can lead to inadequate disclosures related to conflicts, calculation of fees and expenses, and the allocation of such fees and expenses. Outsourcing to vendors to assist with these reporting obligations creates vendor management and oversight obligations as well.

Pitfall 19: Books and Records

The rules include updating the books and records requirements[52] —a mainstay of exam deficiencies[53] —to document and maintain compliance with the new rules. Kroll anticipates that compliance with the books and records requirements will be another of those "low-hanging fruits" pastures for examiners.

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[43] 17 CFR § 275. 211(h)(1)-2.

[44] Adopting Release at 141–42. Similarly, the SEC intends the new annual audit requirement to provide a "check on the adviser's valuation of private fund assets." Adopting Release at 161; see also 17 CFR § 275.206(4)-10.

[45] See, e.g., https://www.sec.gov/enforce/ia-6315-s; https://www.sec.gov/news/press-release/2023-65; https://www.sec.gov/enforce/ia-6040-s; https://www.sec.gov/litigation/litreleases/lr-25542; https://www.sec.gov/ocie/announcement/risk-alert-private-funds

[46] Existing Rule 17 CFR § 275.206(4)-1(e)(1)(i)(B).

[47] See Adopting Release at 212, n. 631.

[48] See https://www.sec.gov/news/press-release/2023-173; https://www.sec.gov/news/press-release/2023-153.

[49] 17 CFR § 275.221(h)(1)-2.

[50] 17 CFR § 275.211(h)(1)-1.

[51] See, e.g., https://www.sec.gov/news/press-release/2023-90.

[52] 17 CFR § 275.204-2(a)(7)(v) & (a)(20)–(24).

[53] See https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf at 5.

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Pitfall 20: Timely Distribution

The new rules require advisers to distribute and keep records of an annual audit and several types of notices with different timing requirements: Some notices are required prior to an action; others within a certain amount of time after; still others "as soon as reasonably practical"; and for some notices, "at substantially the same time."[54] The SEC has already demonstrated that it takes timely distribution seriously, including enforcement actions for failing to distribute audited financials in a timely manner.[55]

Pitfall 21: Limitation of Liability

The SEC decided not to adopt a proposed rule prohibiting advisers from limiting their liability through a waiver or indemnification clauses because it determined a waiver was already invalid under existing fiduciary duty obligations and a violation of the anti-fraud provisions of the Advisers Act.[56] However, the SEC clarified that its position on such waivers or indemnification applies only to an adviser's advisory services.[57] For waivers related to non-advisory services, advisers should be mindful of their overall fiduciary duties.

Pitfall 22: Facts and Circumstances

The Adopting Release refers to "facts and circumstances" determinations under these rules 32 times, some of which are covered above. As discussed above, there are many other analyses, determinations and decisions facing each private fund adviser that will differ based on their unique structure and business. These rules are thus ripe for interpretation and SEC examination and enforcement activity.

Pitfall 23: Risks to Limited Partners

While the new rules increase the operational and regulatory risks to investment advisers, the increased transparency and disclosures also create risks to limited partners who themselves may be fiduciaries. These limited partners may be accused of failing to consider or misinterpreting information in quarterly statements or audited financial statements, or failing to take advantage of preferential treatment rights that are afforded to other investors.

Kroll's team of experts stands ready to leverage our experience in regulatory compliance. We craft policies, procedures, testing, training and recordkeeping specifically designed to help mitigate the risks of noncompliance with the new rules. Kroll specializes in conducting gap analyses and mock examinations aimed at identifying risks and recommending improvements to compliance programs. Additionally, we leverage our expertise to preparing advisers to navigate the complexities associated with examination and investigation inquiries.

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[54] See, e.g., 17 CFR § 275.211(h)(2)-1(a)(2); 17 CFR § 275.211(h)(2)-2(a); 17 CFR § 275.211(h)(2)-3(b)(2)(i) & (ii); 17 CFR § 275.211(h)(2)-3(a)(2).

[55] See https://www.sec.gov/news/press-release/2022-156.

[56] Adopting Release at 256–61; *see also* https://www.sec.gov/enforce/ia-5943-s; https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf at 5.

[57] Sec. Exch. Comm'n, 2023 08 23 Open Meeting, YouTube, at 2:11:19 (Aug. 23, 2023), https://www.youtube.com/watch?v=X6M9PUYB_0s.

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