The SEC's Private Fund Adviser Rules – An Interim Assessment

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On August 23, 2023, the SEC adopted (in a 3-2 vote of the Commissioners) sweeping new rules under the Investment Advisers Act of 1940 (the "Advisers Act") that increase the regulation of advisers to private funds (the "Adopted Rules").[1] These rules represent the most significant overhaul of the regulatory framework since passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which required most private fund advisers to register with the SEC. Being six months into the compliance period, this article reviews ongoing efforts by the private fund industry to implement the Adopted Rules, including addressing some of the ambiguities and interpretive issues left unresolved in the Adopting Release.

The Adopted Rules entail significant compliance challenges and impose significant increased regulatory burdens that will increase costs (including for private fund investors). While several industry groups have challenged the Adopted Rules in the U.S. Court of Appeals for the Fifth Circuit on several grounds, including the SEC's statutory authority to promulgate them, the outcome and timing of that adjudication is uncertain.[2] As a result, advisers would be prudent to continue to prepare to implement the Adopted Rules by the relevant compliance dates.[3] The litigation may also have the unintended effect of slowing or stopping the SEC staff from issuing guidance with respect to issues that advisers are grappling with as they formulate their compliance planning.

Although the Adopted Rules will all require changes to compliance policies and procedures and require advisers to alter current business practices, two rules that arguably have garnered the most attention and discussion during the compliance period to-date are the quarterly statement rule[4] and the preferential treatment rule,[5] which will be the focus of this article. These two rules arguably will have the most lasting impact of the rule package as adopted, and unsurprisingly figure prominently in the legal challenge.

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[1] The Adopting Release is available through this link, and the Fact Sheet summarizing the Adopted Rules is available through this link.

[2] Oral arguments in the case, National Association of Private Fund Managers, et. al. v. Securities and Exchange Commission, were held on February 5, 2024, with a court ruling expected by May 30, 2024.

[3] The effective date of the Adopted Rules is November 13, 2023, with staggered later compliance dates that vary by rule and whether the adviser qualifies as a smaller private fund adviser. Other than with respect to annual written compliance reviews (compliance date November 13, 2023), the earliest of the Adopted Rules' staggered compliance dates is September 14, 2024.

[4] Advisers Act Rule 211(h)(1)-2.

[5] Advisers Act Rule 211(h)(2)-3.

Quarterly Statements Implementation Challenges

The quarterly statement rule requires SEC-registered advisers[6] to prepare and deliver quarterly statements to investors in private funds within 45 days after the end of each of the private fund's first three fiscal quarter and 90 days after the end of the fiscal year (75 and 120 days, respectively, for fund-of-funds). For new funds, the first quarterly statement is due following the second full fiscal quarter of private fund operating results. Absent further SEC guidance, in view of the March 14, 2025, compliance date for this rule, the consensus is that the first quarterly statements will cover Q1 of 2025. For funds with calendar year-ends, these would need to be delivered by May 15, 2025 (or June 14, 2025, for fund-of-funds).

The SEC stated that while most private fund advisers currently provide quarterly statements to investors, not all do, and that the rule is intended to provide investors with a standardized level of minimum information in table form that advisers may supplement with other information under certain conditions. As in the proposal, while the SEC gave examples of information it expected to see in quarterly reports and described in general terms the level of detail required, the adopted quarterly statement rule does not contain a template for advisers to follow (perhaps reflecting the difficulty of the task). The SEC also declined to permit advisers (as requested by commenters) to use a common template previously developed by the Institutional Limited Partners Association ("ILPA") to substitute for compliance with the rule, at least not in its current form. Thus, while the rule is intended to increase transparency by making the reported information more detailed and comparable, advisers were left to determine on their own how to design compliant reports.

The quarterly statements generally will require detailed disclosure in the form of a fund-level table, a portfolio-level table, and standardized performance reporting. The fund-level table must provide, for each private fund, all forms of compensation paid or allocated to the adviser or any of its related persons (e.g., control affiliates and personnel of the adviser) from the private fund during the quarter. In addition, the fund-level table will include *all fees and expenses* paid by or allocated to the private fund, with a separate line item for each category of fee or expense reflecting each total dollar amount. The portfolio-level table must provide, for each portfolio investment of a private fund, all forms of compensation paid or allocated to the adviser or its related persons during the quarter (also shown as separate line items).[7] The performance

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6 The Adopted Rules apply to SEC-registered advisers (except for certain non-U.S. advisers) to private funds, and apply, in part, to non-SEC registered advisers (such as exempt reporting advisers using the mid-sized private fund or venture capital exception) and smaller state-registered advisers. The Adopted Rules do not apply to non-U.S.-domiciled advisers to non-U.S. domiciled private funds (including even those funds with U.S. person investors), whether they are registered with the SEC or not. The Adopted Rules also do not apply to firms outside the definition of "investment adviser," such as family offices relying on the Advisers Act Family Office Rule.

7 Each form of compensation, fees or expenses in both tables must detail the total amount paid or allocated, shown both before and after the application of any offsets, rebates, or waiver.

reporting will present standardized metrics that depend on the fund's determination of whether it is a liquid or illiquid fund for purposes of the quarterly reporting rule.

As the required information generally is more extensive than most advisers currently provide, as a first step, advisers should undertake a gap analysis to confirm whether their existing reporting functions generate the necessary detailed information and produce that information in the timeframe required. As part of this exercise, advisers should identify whether updates to reporting processes and databases are needed and connect soon with external administrators if an increased reliance on administrator services is indicated.

Advisers will also need sufficient time to prepare templates to use to present the required information and consider how current reporting and marketing methods can best be integrated alongside the new requirements. A significant compliance challenge for advisers is deciding how granularly to present each category of required fee or expense, as the Adopting Release provides little guidance. A firm might start by comparing how it currently categorizes fees and expenses in its financial reporting with the examples given in the Adopting Release.[8] While the SEC is not allowing advisers to exclude *de minimis* expenses, group small expenses in broader categories, or use a "miscellaneous" category, it notes that this is because otherwise investors may not have "sufficient detail" to assess and monitor whether expenses borne by the fund conform to agreed-upon terms.

Given these stated goals, it appears a firm could decide to use a broad expense item such as "travel" that is reasonably descriptive of the category of expense generally, perhaps footnoting with explanatory text that it includes lodging, meals, airfare, etc., rather than providing more granular detail in additional sub-line items. Firms would also need to decide how granularly to show expenses such as "legal" that arise in different contexts (e.g., broken deal or organizational), and re-categorize any fees and expenses currently grouped or contained in a miscellaneous category. Some firms may decide to err on the side of providing more granular detail for certain expenses than they currently provide, pending development of (or industry coalescing around) templates that have garnered widespread acceptance, which may or may not happen in time for the March 14, 2025, compliance date for the rule. In February, ILPA announced a project to update the current ILPA template to comply with the quarterly statement rule, with the intention of beginning a public comment period in May 2024 and finalizing the template by July 2024.[9]

With respect to performance reporting for illiquid funds (e.g., private equity), standardized gross and net IRR and MOIC metrics are required for the *full fund portfolio* as of the most recent fiscal quarter (or, if not available, as of the most recent practicable date), since the fund's inception, with gross IRR and MOIC for the *realized and unrealized portions* of the

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[8] See, e.g., Adopting Release at p. 85 (fund fees and expenses would include, but not be limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel) and p. 95 (portfolio investment compensation would include, but not be limited to, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments by a covered portfolio investment to the adviser or related person).

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portfolio, in each case, with and without the use of fund-level subscription facilities. Along with the metrics, illiquid funds must provide a statement of contributions and distributions since inception, and a statement of the fund's net asset value as of the end of the relevant reporting period. Liquid funds (e.g., hedge) must provide net total returns (unlike the metrics for illiquid funds, not defined) on an annual basis subject to a 10-year look-back, average net total return over one- five- and 10-fiscal-year periods, and on a cumulative basis, net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.

An "illiquid fund" is defined as a fund that is not required to redeem interests on an investor's request and has limited opportunities for an investor to withdraw upon the investor's request. A "liquid fund" is any fund other than an "illiquid fund." Advisers must retain substantiating records regarding its determination as to whether a private fund is liquid or illiquid. Open-end real estate and hedge funds or similar funds with periodic redemption rights would appear to be "liquid funds" although the nature of a fund's redemption rights should be evaluated under the definition and documented. The SEC recognized that different types of liquid funds may use different methodologies for calculating net total returns, but an adviser may want to conform to general industry practices for that type of fund (and an adviser should define how it calculates net total returns in the quarterly statement).

For new illiquid funds, performance metrics must be included in the first quarterly report that, as discussed above, is due following the second full fiscal quarter of private fund operating results, before illiquid funds generally report such metrics to their investors today. While these metrics may not provide very meaningful information to illiquid fund investors at such an early stage, the rule permits advisers to supplement their quarterly reports with additional explanatory information under certain parameters, which reasonably could be used to discuss relevant limitations in the data (e.g., "J-curve" effect).

Preferential Treatment Rule Compliance Challenges

Unlike the quarterly statements rule, which was adopted largely as proposed, the preferential treatment rule was significantly modified following the SEC's consideration of public comments received on the proposal. As was proposed, the preferential treatment rule limits the granting of certain preferential redemption rights and information rights to investors, but as discussed below, the Adopted Rule contains certain exceptions intended to allow preferential rights to continue for certain redemptions required by law or regulation, or where the redemption or information right is provided to all investors. In addition, the SEC modified in several respects the proposal's requirements that written notice of preferential rights be provided to prospective and current investors in a fund. Finally, the SEC extended "legacy status" (e.g., grandfathering) to contractual agreements governing redemption or information rights entered prior to the compliance date (September 14, 2025, for larger private fund advisers and March 14, 2025, for smaller private fund advisers) for a fund that has commenced operations.

While the SEC stated that the modifications were designed in part to address the concerns of limited partner investors that they would no longer to be able to secure important side letter provisions that are a prerequisite for their participation in the private funds market, the changes added significant complexity and compliance burdens to the rule, and as discussed below, left

many questions unanswered. In addition to these challenges, the preferential treatment rule will necessitate changes in current practices in significant ways that will ripple across many firm departments, not limited to the compliance function.

The preferential treatment rule is broadly written to encompass all grants of preferential treatment in any form and need not be in a formal side letter. Thus, the first challenge for advisers is to undergo a scoping exercise to determine where preferential treatment has been granted. For example, agreements with large investors where the adviser has a strategic relationship across multiple funds or arrangements with minority investors in the adviser that also have arrangements with respect to their investments in the adviser's private funds may, upon analysis, be subject to the preferential treatment rule.

As noted above, the Adopted Rule is complex and multi-faceted and consists of a redemption rights prohibition, an information rights prohibition, and disclosure requirements (both *pre-commitment* disclosure to prospective investors, and *post-commitment and annual* disclosure to all investors). The rule's requirements have different impacts on the business practices of closed-end (illiquid) funds such as private equity funds, as compared with open-end (liquid) funds such as hedge funds, as further discussed below.

Redemption Rights Prohibition

Under the redemption rights prohibition, advisers are prohibited from, directly or indirectly, providing preferential treatment with respect to redemption rights that the adviser reasonably expects to have a material, negative effect ("MNE") on other investors in that private fund or a similar pool of assets,[10] *unless* (1) the redemptions are *required pursuant to applicable law*, rule, regulation or an order of certain government authorities, or (2) the adviser offers the same redemption rights *to all existing and future investors* in that private fund or any similar pool of assets without qualification (e.g., not based on commitment size, affiliation requirements or other limitations).

While this prohibition will have a significant effect on hedge funds or similar funds that offer redemptions, its impact on private equity and other illiquid funds is expected to be muted due to the very limited ability of investors to withdraw from an illiquid fund before the end of its investment period. Despite urging from commenters, however, the SEC did not provide an exemption for closed-end illiquid funds from any of the requirements of the Adopted Rule. As a result, all private funds must examine the redemption, withdrawal and/or liquidity rights they offer to determine if they are prohibited under the rule. This will entail evaluating whether a redemption right exists that reasonably is expected to produce a MNE and if so, whether it falls within one of the two exceptions noted above.

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[10] Similar pool of assets is defined as a pooled investment vehicle (other than a registered investment company of business development company) managed by the adviser or its related persons, with substantially similar investment policies, objectives, or strategies to those of the private fund. The SEC altered the defined term from "substantially similar pool of assets" (as proposed) to signal the broad scope of the term. The SEC noted that the term will capture feeder funds, parallel funds, funds-of-one, and co-investment vehicles. Under the rule, a similar pool of assets is not limited to parallel private funds and can include other types of pooled vehicles (e.g., section 3(c)(5) vehicles).

When discussing the prohibition, the SEC focused on the potential harm to the fund and other investors and the possible dilutive effects from the sale of more liquid fund assets to satisfy a preferred investor's exit. However, the adopting release does not define "redemption" and did not consider how or if certain rights granted in illiquid funds (e.g., opt-out rights, transfer rights, withdrawal rights over time) could ever be considered a "redemption" or create the possibility of a MNE when they do *not* involve a sale of fund assets or create dilution. These difficulties are compounded by the SEC's failure to define or give much context around what would constitute a MNE, other than to state that it is a "facts and circumstances" analysis.

The adopting release contemplates that ERISA, state pay-to-play statutes, or banking requirements qualify for the "required by law" exception to the prohibition. On the other hand, redemption rights commonly granted to large, institutional investors (e.g., sovereign wealth funds) based on investment policy provisions to which they are subject, would generally not be "required by law" and would be prohibited if there is a MNE on other investors. That the adopting release does not provide much help in understanding *what is a MNE* in different situations complicates the analysis for both the redemption rights prohibition and the information rights prohibition, discussed below.

Information Rights Prohibition

Under the information rights prohibition, advisers are prohibited, directly or indirectly, from providing preferential treatment with respect to enhanced information relating to portfolio holdings or exposures ("information rights") that the adviser reasonably expects to have material negative effect (MNE) on other investors in that private fund or in a similar pool of assets, unless the adviser offers such information rights to all other existing investors in that private fund or in a similar pool of assets at the same or substantially the same time. Like with the redemption rights prohibition, the SEC did not address how or when information would be considered a prohibited information right other than to state generally that not all information rights will have a MNE on other investors. Note that not all information rights are covered, only those related to portfolio holdings or exposure that are reasonably expected to have a MNE on other investors.[11]

The SEC noted than an investor's ability to redeem is an important part of determining whether providing information rights would have a MNE on other investors and that, generally, it would not view preferential information rights in an "illiquid" fund as having a MNE on other investors. Although unlikely to produce a MNE, the SEC did not provide a blanket exception or provide any guidance other than to repeat that it is a facts and circumstances analysis and that even closed-end private funds offer redemption rights in certain extraordinary circumstances and that there may be some "front-running" potential in certain circumstances. Thus, closed-end fund advisers will need to assess situations where investors with access to additional information about portfolio holdings or exposures may be able to act in ways that could harm other investors, even in the absence of redemption rights.

The prohibition has more saliency, and the possibility of a MNE higher, with respect to open-end funds such as hedge funds due to the liquid nature of their portfolios, much of which

[11] Information rights generally not expected to have a MNE would include information related to an investor's individual tax or regulatory circumstances.

may be publicly-traded, coupled with redemption ability. Given the lack of clarity around what constitutes a MNE, evaluating every information right granted preferentially after the compliance period will be daunting. The prohibition does not apply, and the analysis would not be needed, however, with respect to information offered to all investors. The SEC acknowledge as much in the adopting release, when it stated that the exception should allow advisers to discuss their portfolio holdings during investor meetings so long as all investors have access to the same information.

Pre-Commitment Disclosure of Material Economic Terms

For preferential treatment provided to other investors in the same private fund, advisers must provide advance written notice to prospective investors. In a change from the proposal, the SEC in the Adopted Rule limited the advance written notice requirement to apply only to "material economic terms" (MET). The SEC did not define MET other than to state that these are terms that a prospective investor would find "most important and that would significantly impact its bargaining position" and gave the following examples: cost of investing, liquidity rights, fee break, and contractual co-investment rights.

While the examples are somewhat helpful, they are merely illustrative, and a full analysis will be required for advisers to identify all side letters or other arrangements that contain terms that may be considered METs. Disclosure of METs involving fee breaks must be disclosed with specificity, which means providing the specific percentage or range of percentages. Terms that do not rise to a MET are subject only to post-commitment disclosure (see below). Conversely, providing advance written notice of *all* preferential treatment granted to investors in the fund to prospective investors eliminates the need to determine which terms rise to the level of a MET.

Note that the disclosure aspects of the preferential treatment rule refer to the "the same private fund" and do not include (and is narrower than) the concept of "similar pool of assets." The term "same private fund" is not defined in the Adopted Rule or the adopting release.

In addition, with respect to pre-commitment disclosure of preferential treatment containing METs, because the SEC did not outline a recommended approach, an adviser needs to decide the timing, method, and format of the written disclosure. The rule requires only that such advance written disclosure occur prior to investment, leaving several logistical issues for advisers to resolve. These include decisions with respect to when a side letter has been finalized to the point it must be disclosed in a fund multiple closings, how to disclose side letters that are expected to be entered into at the same time as the relevant closing, and how much time to allot between the disclosure and the closing so as not to create an unmanageable loop of disclosures and re-negotiations.

Post-Commitment Disclosure Requirement

For all other preferential treatment provided that are not METs, advisers must provide notice to investors as soon as reasonably practicable (generally within four weeks) following: for illiquid funds, the end of the private fund's fundraising period; for liquid funds, the date of the investor's investment. Several options for compliance with the post-commitment disclosure requirement include posting all side letters in redacted form to a data room; using an MFN-type

document adapted to the SEC's anticipated 4-week timetable for delivery of the disclosure; or posting to a data room a summary or compendium of all side letters "with specificity" (which could introduce the possibility of errors or omissions and added expense).

Annual Disclosure Requirement

In addition to the pre-and post-commitment disclosures, advisers are required to provide current investors, on at least an annual basis, comprehensive disclosure of all preferential treatment the adviser has provided "since the last notice." The SEC noted that a private fund that does not admit new investors or provide new terms to existing investors following the end of its fundraising period for which disclosure of preferential terms has been made does not need to deliver an annual notice. However, in the closed-end fund context, new disclosure obligations could arise in circumstances where private fund advisers enter into new side letters with a transferee in connection with an investor transfer. It is unclear whether the SEC expects advisers to provide annual disclosures following the relevant compliance dates for private funds that are no longer actively fundraising as the September 14, 2024, or March 14, 2025, applicable date but have not liquidated or wound up. While it is unclear whether this was the SEC's intent (the burdens would be significant and lacking a clear policy purpose), note that the SEC did not extend legacy status with respect to the preferential treatment rule's disclosure requirements.

Conclusion

Even without the litigation challenge, as has been seen with the adoption of the amendments to the marketing rule under the Advisers Act, it is unlikely the industry will receive any timely guidance from the SEC staff regarding the Adopted Rules and instead will learn of the SEC staff's interpretations of the rule through the examination and deficiency process. Accordingly, advisers should consult with their counsel to ensure they understand the varying interpretations of the various provisions of the Adopted Rules to decide how they will seek to comply given their specific business operations.