ONPOINT / A legal update from Dechert's Financial Services Group

The SEC's Private Fund Adviser Rules: Exploring the Critical Questions

Authored by David P. Bartels, Sonia R. Gioseffi, Michael W. McGrath, Jennifer A. DiNuccio, Phillip Garber, Lindsay R. Grossman, Derek Manners, and Michael Murphy

October 2023

Dechert LLP

The SEC's Private Fund Adviser Rules: Exploring the Critical Questions

October 2023 / David P. Bartels, Sonia R. Gioseffi, Michael W. McGrath, Jennifer A. DiNuccio, Phillip Garber, Lindsay R. Grossman, Derek Manners, and Michael Murphy

The Securities and Exchange Commission adopted new and amended rules under the Investment Advisers Act of 1940 ("**Final Rules**") in August 2023 that will impose a broad set of new reporting, disclosure and other obligations on advisers to Private Funds ("**Private Fund Advisers**").[1] The Final Rules have five main components: the "**Quarterly Statements Rule**," "**Audit Rule**," "**Adviser-Led Secondaries Rule**," "**Restricted Activities Rule**," and "**Preferential Treatment Rule**."[2]

The Final Rules also amend Rule 204-2 under the Advisers Act ("**Recordkeeping Rule**"), to require Private Fund Advisers to retain certain documents relating to the Final Rules. While unrelated to its focus on Private Funds, the SEC also amended Rule 206(4)-7 under the Advisers Act ("**Compliance Rule**") to require all registered investment advisers (even those that do not manage Private Funds) to document their annual reviews of their compliance policies and procedures in writing.

We have summarized the Final Rules in our *Dechert NewsFlash* and advisers may find particularly helpful the *Quick Reference Guide*, which breaks down the Final Rules based on type of adviser and type of fund. Below, we provide practical insights on applying the Final Rules in response to critical questions from Private Fund Advisers.

While the Final Rules do not reflect certain of the more extreme and contentious components of the February 2022 rule proposal,[3] the Final Rules have nonetheless generated significant criticism from the industry. A group of six trade associations has filed a petition for review with the Fifth Circuit Court of Appeals challenging the SEC's statutory authority to adopt and enforce the Final Rules.[4] While the legal challenge is pending, there will be uncertainty regarding the shape of the Final Rules. For example, we may not know for some time whether all or part of the Final Rules will stand. The trade associations have requested (without objection from the SEC) that the court issue a ruling by May 31, 2024, halfway to the first compliance date.

1. When should Private Fund Advisers begin work to implement the Final Rules?

The SEC established the following "**Compliance Dates**":

Rule	Compliance Date
Amended Compliance Rule	November 13, 2023

1 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-6383 (Aug. 23, 2023) ("**Adopting Release**"). A "**Private Fund**" is a fund that would be an investment company under the Investment Company Act of 1940, but for Sections 3(c)(1) or 3(c)(7).

2 The Final Rules are designated as Rule 211(h)(1)-2, Rule 206(4)-10, Rule 211(h)(2)-2, Rule 211(h)(2)-1 and Rule 211(h)(2)-3, respectively.

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

4 Petition for Review, National Association of Private Fund Managers; Alternative Investment Management Association; American Investment Council, Loan Syndications and Trading Association; Managed Funds Association; and National Venture Capital Association v. Securities and Exchange Commission (Sep. 1, 2023).

Amended Recordkeeping Rule	November 13, 2023
Adviser-Led Secondaries Rule, Preferential Treatment Rule and Restricted Activities Rule for Private Fund Advisers with $1.5 billion or more in Private Fund assets under management **(AUM**)	September 14, 2024
Adviser-Led Secondaries Rule, Preferential Treatment Rule and Restricted Activities Rule for Private Fund Advisers with less than $1.5 billion in Private Fund AUM	March 14, 2025
Quarterly Statement Rule and Audit Rule	March 14, 2025

It is unclear how the trade group legal challenge will affect implementation. However, given the short implementation periods and the significant operational and legal work that will be required, advisers should begin planning for compliance as soon as possible. In addition to assessing adjustments to terms and documentation for upcoming funds, advisers may need to consider:

- Operational changes necessary for investor reporting and notice requirements, with reporting and notice deadlines that in many cases do not align across rules.
- Methods for identifying and designating fund expenses in a manner consistent with the Quarterly Statement Rule when such expenses are incurred, which will need to be implemented in advance of the applicable Compliance Date.
- Recordkeeping requirements that will necessitate capturing a number of new datapoints to demonstrate compliance with the Final Rules.
- Updating policies and procedures and training as necessary to reflect the foregoing.
- The Final Rules' grandfathering (or legacy status) provisions and how they apply to funds and side letters existing before the applicable Compliance Date.
- The disclosure of preferential treatment to new and existing investors upon the applicable Compliance Date.
- Allocation of responsibilities between advisers and sub-advisers.

2. Are my funds impacted by the Final Rules?

The Final Rules apply only to "Private Funds," which has a technical meaning under the Advisers Act that can differ from more colloquial uses of the term. As defined for purposes of the Advisers Act, Private Funds include only funds that would be investment companies but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act. As such, the Final Rules do not apply with respect to registered funds, business development companies, collective investment trusts, or other funds that are able to rely on another exception or exemption from investment company status, such as funds that are able to rely on Section 3(c)(5) of the Investment Company Act.

Our ***Flow Chart for Fund Sponsors*** can be used to assess the applicability of the Final Rules to a particular fund, though more complex arrangements will require case-by-case analysis. We have also outlined the applicability of the Final Rules for various types of managers below.

Private Fund Advisers (Regardless of Registration Status)

All Private Fund Advisers, including SEC-registered advisers, exempt reporting advisers (**ERAs**), state-registered advisers and advisers otherwise exempt from registration, are subject to the Restricted Activities Rule and the Preferential Treatment Rule.

Additionally, all Private Fund Advisers have a fiduciary obligation to act in a Private Fund's best interest and to make full and fair disclosure of all conflicts and material facts such that an investor can provide informed consent. Although proposed requirements were dropped from the Final Rules related to agreements limiting the liability of advisers and the ability of advisers to charge fees for services that are not performed, the SEC provided guidance asserting that the fiduciary duties of advisers impose requirements similar to those that were proposed. See Question 12 below for further discussion.

Private Fund Advisers that are SEC-Registered Investment Advisers

Private Fund Advisers that are registered investment advisers ("**Private Fund RIAs**") are subject to all five Final Rules. In addition to those applicable to all Private Fund Advisers, these include the Quarterly Statement Rule, the Audit Rule and the Adviser-Led Secondaries Rule.

Private Fund RIAs must also comply with the corresponding recordkeeping requirements in the amended Recordkeeping Rule at the time the Private Fund RIA begins complying with the corresponding substantive Final Rules. Although ERAs, state-registered advisers and other Private Fund Advisers not subject to registration must comply with the Restricted Activities Rule and the Preferential Treatment Rule, they are not subject to the corresponding recordkeeping requirements.

Considerations for Offshore Private Fund Advisers and Advisers to Offshore Private Funds

The applicability of the Final Rules to a Private Fund organized outside of the United States (e.g., UCITS, AIF, Luxembourg fund, Cayman fund) (an "**Offshore Private Fund**") will differ based on the location of the Offshore Private Fund's adviser. The Final Rules do not apply to a Private Fund Adviser with a principal place of business outside the United States (an "**Offshore Private Fund Adviser**") with respect to any Offshore Private Fund even if the Offshore Private Fund has US investors.[5]

However, the Final Rules do apply to a Private Fund Adviser with its principal place of business in the United States with respect to all Private Funds, including U.S. Private Funds and Offshore Private Funds. Therefore, for example, a U.S.-based manager to a UCITS fund *will* be subject to the Final Rules with respect to the fund if the fund is privately offered in the United States, but an Offshore Private Fund Adviser to the same UCITS fund would not be subject to the Final Rules.

A Private Fund Adviser that manages one or more funds with respect to which it is not subject to the Final Rules may, nevertheless, face considerations related to the Final Rules. This may, for example, be the case where those funds are "similar pools of assets" relative to a Private Fund with respect to which the Private Fund Adviser is subject to the Final Rules.

[5] Though not defined in the Final Rules, the SEC has previously defined an adviser's "principal office and place of business" in Rule 203(m)-1 and Rule 203A-3 under the Advisers Act.

Securitized Asset Fund Managers

In response to industry comments, the SEC provided an explicit exception from all five Final Rules for any Private Fund that is a securitized asset fund (**SAF**). A SAF is a fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt-holders, such as collateralized loan obligations (**CLOs**) and other securitization vehicles. The definition of "securitized asset fund" aligns with a definition that has been used in Form PF for the last decade, which should aid in identifying applicable funds. The exception does not extend to CLO equity funds, which typically do not issue debt securities. The SEC also indicated in the Adopting Release that rated note funds would generally not be viewed as SAFs.[6]

Although CLOs are not subject to the Final Rules, CLO managers remain subject to Section 206 and Rule 206(4)-8 under the Advisers Act, which impose general antifraud standards with respect to the CLOs managed.

Funds Relying on Section 3(c)(5), Including Certain Real Estate Funds

A real estate fund that is able to rely on Section 3(c)(5)(C) of the Investment Company Act, or any other closed-end fund that is able to rely on Section 3(c)(5), is not a "Private Fund." Accordingly, the manager is not subject to any of the Final Rules with respect to that fund. Although a fund that is able to rely on Section 3(c)(5) may also rely on Section 3(c)(7), such a fund will not meet the definition of a "Private Fund" by virtue of its additional ability to rely on Section 3(c)(5).

Subadvisers to Private Funds

A registered investment adviser that serves as a subadviser to a Private Fund with a third-party manager may have certain obligations under each of the Final Rules. For two of the Final Rules, the SEC clarified the responsibilities of a subadviser:

- *Quarterly Statements*. A subadviser must prepare and distribute quarterly statements to Private Fund investors only if the primary adviser does not distribute quarterly statements.[7]

- *Audits*. A subadviser must take "all reasonable steps" to ensure that the Private Fund undergoes an audit and distributes audited financial statements pursuant to the Audit Rule.[8] The Final Rules do not define what would constitute "reasonable steps," but the SEC stated that obtaining (or seeking to obtain) a representation from the primary manager in a subadvisory agreement would be considered reasonable steps.

Subadvisory arrangements vary widely, including with regard to whether the primary adviser is a third-party or an affiliate. Accordingly, the application of the Final Rules to these arrangements will require case-by-case analysis and to the extent the Final Rules may apply to a subadviser, the subadviser should consider negotiating with the primary adviser the allocation of responsibilities under the Final Rules.

---

6 Adopting Release at n. 156.

7 Adopting Release at n. 197.

8 These requirements are consistent with the requirements of the audit exception in Rule 206(4)-2 under the Advisers Act ("**Custody Rule**").

3. How will the Final Rules impact co-investment vehicles, funds of one and separately managed accounts?

The impact of the Preferential Treatment Rule and Restricted Activities Rule will not be limited to an individual Private Fund that is the direct subject of the rules and Private Fund Advisers will need to consider other Private Funds they manage, co-investment vehicles, funds of one and separately managed accounts (**SMAs**) when complying with the rules.

The Preferential Treatment Rule

The Preferential Treatment Rule restricts Private Fund Advisers from providing preferential redemption rights or information regarding portfolio holdings or exposures to an investor in a Private Fund or a similar pool of assets if the preferential treatment would reasonably be expected to have a material, negative effect on other investors in the Private Fund or in a similar pool of assets.[9]

The rule defines "**similar pool of assets**" broadly and may include other Private Funds, feeder funds, parallel funds, proprietary vehicles, alternative investment vehicles and certain co-investment vehicles. In addition, the SEC stated that the definition will likely capture funds beyond what the industry would consider substantially similar, asserting illustratively that "an adviser's healthcare-focused Private Fund may be considered a 'similar pool of assets' to the adviser's technology-focused Private Fund."[10] At the same time, the Preferential Treatment Rule restricts preferential liquidity and information rights only where the adviser reasonably expects a material, negative effect on other investors in the relevant Private Fund or in a similar pool of assets. This may serve to temper the breadth of the "similar pool of assets" definition, particularly where the pools do not have substantially similar portfolios and assessing whether terms are reasonably expected to have a material, negative effect is likely to be a critical exercise in applying the rule.

The SEC did not include SMAs in the definition of "similar pool of assets." With respect to "funds of one," some case-by-case analysis may be necessary as the SEC stated that there are "circumstances in which a fund of one or single investor fund can be a pooled investment vehicle and therefore can fall within the definition of 'similar pool of assets.'"[11]

The Restricted Activities Rule

The Restricted Activities Rule, among other things, limits the ability of a Private Fund Adviser to charge or allocate fees or expenses related to a portfolio investment on a non-pro rata basis when multiple Private Funds and *other clients* have invested in the same portfolio investment. For this purpose, "other clients" may encompass both other Private Funds and SMAs. Under the rule, a Private Fund Adviser may charge or allocate fees on a non-pro rata basis only if: (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 adviser distributes to each investor of the Private Fund a written notice of the non-pro rata charge or allocation and a description of

---

9 The rule provides exceptions where the redemption rights are required by law or where the redemption or information rights are offered to all investors in the Private Fund and any *similar pool* of assets.

10 Adopting Release at 286. However, the Adopting Release also notes that a pool of assets with a materially different target return or sector focus, for example, would likely not have substantially similar investment policies, objectives, or strategies to those of the subject Private Fund, depending on the facts and circumstances and therefore would not constitute a *similar pool* of assets. Adopting Release at 287.

11 Adopting Release at 289.

how it is fair and equitable under the circumstances. See Question 15 for a discussion on how to determine whether charging an expense on a non-pro rata basis is fair and equitable.

4. What are "material economic terms," as used in the Preferential Treatment Rule?

Material economic terms are terms a prospective investor would: (i) find most important; and (ii) significantly impact such investor's bargaining position.[12] Material economic terms include, but are not limited to, those relating to the cost of investing, liquidity rights, fee breaks and co-investment rights (whether or not they include materially different fee and expense terms from the main fund).[13] Preferential treatment that would create a conflict of interest or otherwise make existing fund terms misleading may also be material economic terms, for example, where a Private Fund Adviser limits or narrows a fund's overall investment strategy via a side letter provision with one investor.[14]

5. Do I need to update my governing documents for existing Private Funds?

The SEC acknowledged that Private Fund Advisers and investors of existing Private Funds have already negotiated and agreed to terms and, accordingly, afforded "legacy status" to certain agreements under the consent requirements of the Preferential Treatment Rule and the Restricted Activities Rule where application of the rules would require amending those agreements. Consequently, Private Fund governing documents generally do not need to be amended to comply with these requirements of the Final Rules.

That said, disclosure in governing documents and Form ADV should be consistent with actual practice and not be otherwise misleading. Advisers should therefore review applicable fund governing documents to confirm consistency, particularly with respect to the requirements of the Quarterly Statement Rule, the Audit Rule and the disclosure-only requirements for the Preferential Treatment Rule and the Restricted Activities Rule.[15]

In addition, Private Fund RIAs will be required, in the quarterly statements, to cross-reference (i.e., to map) the applicable governing document provisions that permit the charging or allocating of certain fees and expenses to the Private Fund. Accordingly, Private Fund RIAs should review the relevant provisions of existing governing documents for purposes of referencing the fee and expense disclosures in the quarterly statements.

To the extent Private Fund Advisers make any updates to fund governing documents to address any of the Final Rules, they should consider whether any corresponding updates are needed to their Form ADVs, in particular, the Part 2A brochure, and Form PF. Advisers should also ensure their reporting processes implemented for the Quarterly Statement Rule align with other processes that may already be in place (e.g., compliance with CFTC Rule 4.7 and electronic delivery requirements).

6. Do my existing funds have legacy status?

For the provisions of the Restricted Activities Rule and the Preferential Treatment Rule for which legacy status is available, legacy status will only apply to an agreement: (i) for a Private Fund that commenced operations before the applicable Compliance Date; (ii) where the agreement itself was entered into prior to the Compliance Date;

---

12 Adopting Release at 298-99.

13 Adopting Release at 294 and n. 882.

14 Adopting Release at 293.

15 Currently, there are no specific requirements for advisers regarding disclosure of a Private Fund's investments, performance and fees and expenses to investors beyond the antifraud provisions of the federal securities laws, applicable requirements under the private placement rules, the Advisers Act Custody Rule (where a fund relies on the audit exemption) and the Marketing Rule.

and (iii) where applying the relevant rule would require parties to amend such agreement. Commencement of operations means any bona fide activity directed towards operating a Private Fund, including investment, fundraising, or operational activity. Such activities include issuing capital calls, setting up a subscription facility, holding an initial closing, conducting due diligence on potential fund investments, or making an investment.

Private Fund Advisers do not need to offer such preferential liquidity rights in a side letter with legacy status to all investors after the applicable Compliance Date, provided the adviser does not add investors to such side letter. However, advisers can add investors to existing funds through classes established within a Private Fund prior to the Compliance Date.[16]

7. How should documents for funds launching after the Compliance Dates be updated?

Although the Final Rules require a Private Fund RIA to prepare and deliver certain documents, they do not require specific operating agreement provisions or specific disclosures on Form ADV. Accordingly, rather than draft governing documents to enshrine the specific requirements, a Private Fund RIA may take a more evergreen approach. For example, with respect to the Quarterly Statement Rule and the Audit Rule, Private Fund governing documents may reference compliance with "applicable regulatory requirements," rather than the specific content and timing requirements, to afford flexibility to address different Compliance Dates as well as the potential for future changes to the Final Rules or for all or part of the rules to be vacated.

However, Private Fund Advisers should ensure that governing documents do not conflict with actual practice and are not misleading. Similarly, advisers should consider that the Quarterly Statement Rule will require fees and expenses charged or allocated to the Private Fund to be cross-referenced to the fund's governing documents so that investors may compare what the fund is obligated to pay to what the fund actually paid during the reporting period. In drafting governing documents, Private Fund RIAs should anticipate that the staff of the SEC's Division of Examinations will closely scrutinize this ticking-and-tying exercise.

Additionally, Private Fund Advisers may want to consider adding to their governing documents appropriate consent processes where they may be needed under the applicable Final Rules, including where the consent of the Limited Partner Advisory Committee or other similar bodies may not meet the consent requirements under the Final Rules.[17]

8. How will the Final Rules impact my negotiations with investors?

Even in advance of the Compliance Dates, Private Fund Advisers may need to consider if the terms they offer to investors will be considered preferential, what kinds of preferential redemption or information rights would reasonably be expected to have a material, negative effect on other investors and when economic terms would be considered material.[18] Accordingly, Private Fund Advisers should consider updating or otherwise implementing processes to: (i) address how they will make these determinations; and (ii) ensure that any such preferential treatment is offered and/or disclosed in accordance with the Preferential Treatment Rule.

---

16 See Adopting Release at text following n. 960 ("we would not view an adviser to a fund who admits new investors to an existing fund as violating the legacy provisions to the extent the applicable terms are set forth in the fund's limited partnership (or similar) agreement and applicable to all investors").

17 For applicable provisions of the Preferential Treatment Rule and Restricted Activities Rule, a Private Fund Adviser must obtain consent from a majority in interest of Private Fund investors unrelated to the adviser, and the adviser may provide for a higher threshold of consent. *See, e.g.*, Adopting Release at 209.

18 Private Fund Advisers may also consider whether any preferential redemption rights offered to investors are required by law.

While Private Fund Advisers may have processes in place to account for "most favored nations" clauses (**MFNs**) negotiated in side letters that could be repurposed, such processes will need to be updated to account for distributing information to all investors, not just those with MFNs.

Advisers will be required to disclose "material economic terms" (see Question 4 above) to each investor prior to such investor's investment in the Private Fund. Practically, this disclosure process can be accomplished through materials that are provided to investors immediately before closing, such as by posting in data rooms.[19]

Advisers will also be required to disclose other preferential terms as soon as reasonably practicable following the investor's investment in the Private Fund (for liquid funds), or as soon as reasonably practicable following the end of the Private Fund's fundraising period (for illiquid funds). In each case, "as soon as reasonably practicable" depends on the facts and circumstances but, in the SEC's view, should generally be within four weeks of the relevant start date.[20] With respect to new investors receiving either material economic terms or other preferential treatment after other investors were already admitted, such terms would be disclosed to existing investors as part of an annual notice requirement of the Preferential Treatment Rule.[21] A Private Fund that neither admits new investors nor provides new terms to existing investors following the most recent prior notice would not need to deliver an annual notice.[22]

Private Fund Advisers should also consider whether they are subject to other, similar disclosure requirements (such as the side letter disclosure obligations under the EU Alternative Investment Fund Managers Directive) and how to reconcile conflicting disclosure obligations.

9. In how much detail do I need to present fees and expenses in the quarterly statement fund table?

The quarterly statement fund table must capture all fees, expenses and other forms of compensation paid by a Private Fund, with distinct line items for each category of compensation. "Fund expenses" are all fees and expenses allocated to or paid by the fund, including organizational, accounting, legal, administration, audit, tax, due diligence and travel fees and expenses. "Adviser compensation" is all compensation, fees and other amounts allocated or paid to the adviser or any of its related persons, and includes management, advisory, sub-advisory and performance-based fees. There is no exception from this requirement for non-material expenses—Private Fund Advisers are prohibited from excluding de minimis expenses, grouping smaller expenses together into broader categories, or identifying any expenses as "miscellaneous."

To the extent that a fund expense could also be characterized as adviser compensation, it must be disclosed as adviser compensation rather than as a fund expense. For example, compensation paid to a related person that provides consulting, legal, or back-office services should be categorized as adviser compensation.[23]

Additionally, all fees, expenses and other compensation reported on a quarterly statement must be reflected both before and after any offsets, rebates, or waivers. This is the case even if the fee reduction is applicable only to a

---

[19] To satisfy the disclosure of material economic terms and preferential terms, advisers may provide copies of side letters or a written summary of the preferential terms provided to other investors in the Private Fund, provided the summary describes the terms granted with enough specificity. Material economic terms generally do not need to be included in marketing materials or otherwise part of the marketing process for a Private Fund.

[20] Adopting Release at 298-99.

[21] *Id*.

[22] Adopting Release at n. 893.

[23] Adopting Release at 86-87.

subset of investors. A prominent description must be included alongside the information, but the identity of the subset of investors does not need to be disclosed.[24]

Private Fund RIAs should consult with their fund administrators well in advance of the applicable Compliance Date to clarify responsibilities for gathering and computing expense information in quarterly statements. Given the level of granularity required in the reporting, Private Fund RIAs should consider instituting a process to identify and track all expenses as fund- or adviser-related expenses. This process will likely require changes not only to internal operations, but also adjustments to a Private Fund RIA's interactions with service providers and the manner in which those expenses are tracked.[25]

10. How do I satisfy the Quarterly Statement Rule if I am not able to calculate the required performance for an illiquid fund prior to the required distribution date?

Quarterly statements must be distributed within 45 days after the end of each of the Private Fund's first three fiscal quarters and within 90 days after the end of the fiscal year. For Private Funds that are funds of funds the timeline is longer—within 75 days and 120 days, respectively.

The Quarterly Statement Rule requires a Private Fund RIA to include performance measures for an illiquid fund from inception through the end of the quarter covered by the quarterly statement. To the extent that performance cannot be calculated in advance of the distribution deadline (e.g., because information for portfolio investments or other third parties is necessary to generate the performance), the quarterly statement may instead include performance through the end of the prior quarter. So, for example, a statement distributed on August 15 may include performance as of March 31 if performance as of June 30 is not available. The "as of" date of the performance information must be provided in the statement.

11. How will the new Quarterly Statement Rule interact with the Marketing Rule?

A quarterly statement that is provided exclusively to existing Private Fund investors and only contains information regarding an investor's existing investment in a Private Fund is not an "advertisement" for purposes of Rule 206(4)-1 under the Advisers Act (the "**Marketing Rule**") and is not subject to the rule's substantive requirements. However, a quarterly statement could be transformed into an advertisement in a number of circumstances, including if it is distributed to prospective investors to provide performance updates, or if the adviser offers new or additional advisory services in the statement. Merely posting quarterly statements in a data room accessible by prospective investors could also implicate the Marketing Rule.[26] Specific considerations for quarterly statements that are also advertisements (as defined in the Marketing Rule) include the following:

- *Extracted Performance*. the Quarterly Statement Rule requires illiquid funds to present separately the gross IRR and gross MOIC of the realized and unrealized portions of the portfolio. However, an advertisement that includes this required performance information will *not* satisfy the Marketing Rule requirement to present all performance (including extracted performance) on a net basis. Accordingly, before sharing the quarterly statement in a context that would cause it to be deemed an advertisement,

---

[24] Adopting Release at n. 257.

[25] Similar processes regarding the allocation of expenses incurred by portfolio investments are also warranted, as the portfolio investment table must include a detailed accounting of all portfolio investment compensation allocated or paid to the investment adviser or any of its related persons.

[26] *See* Investment Adviser Marketing, Release No. IA-5653 (Dec. 22, 2021) at n. 195 and accompanying text ("While due diligence rooms themselves are not advertisements, it is possible that some of the information they contain could qualify as an advertisement if the materials satisfy the requirements of the advertisement definition.") ("**Marketing Rule Release**"). It is unclear whether the SEC staff would consider quarterly statements to be "advertisements" in this context.

fund managers should consider supplementing the quarterly statement with net IRR and net MOIC of both the realized and unrealized portions of the Private Fund. This performance should be presented with equal prominence to the required gross IRR and gross MOIC in a format designed to facilitate comparison.

- *Model Fees*. For both liquid and illiquid funds, the presentation of net performance calculated based on actual fund fees may be inconsistent with statements in the Marketing Rule adopting release that if the fee to be charged to the intended audience is anticipated to be higher than the actual fees charged, the adviser *must* recalculate Private Fund performance using a model fee that reflects the anticipated fee to be charged. For example, while it is permissible under the Final Rules to use a management fee rate averaged across different classes to compute fund-level performance (with accompanying prominent disclosure), this performance may not comply with the SEC's Marketing Rule guidance if provided to a prospective investor in a high-fee share class.[27]

Notably, the Quarterly Statement Rule requires illiquid funds to compute and present performance both with and without the impact of fund-level subscription facilities. While acknowledging that performance calculated with the impact of a subscription facility usually reflects the actual return to investors, the SEC voiced a concern that these "levered" performance figures, alone, have the potential to mislead investors. Although it contains several prescriptive provisions regarding the computation and presentation of investment performance, there is no corresponding requirement in the Marketing Rule to compute and present in an advertisement the hypothetical performance that a fund would have earned absent the effect of a fund-level subscription facility. The discussion in the Adopting Release suggests that SEC staff may interpret the Marketing Rule's general prohibitions to require similar performance presentations in advertisements.[28]

12. Will guidance in the adopting release be used to enforce unpopular aspects of the Proposal that were dropped from the Final Rules?

The SEC did not adopt controversial components of the proposed rules that would have prohibited indemnification and exculpation clauses extending to an adviser's own negligence and charging fees for services that have not been or are not expected to be performed. However, the SEC asserted in the Adopting Release that certain of this conduct may nevertheless violate existing law, at least under certain facts and circumstances.

In addressing indemnification and exculpation, the SEC reiterated its view that, "[a] waiver of an adviser's compliance with its Federal antifraud liability for breach of its fiduciary duty to the Private Fund or otherwise, or of any other provision of the Advisers Act, or rules thereunder, is invalid under the Act."[29] The Adopting Release further notes that the SEC has brought enforcement actions in cases where a contract has waived any and all of the adviser's fiduciary duties or explicitly or generically waived the adviser's Federal fiduciary duty when such provisions were not accompanied by a sufficient savings clause.[30] Although this section of the Adopting Release purports to state longstanding views of the SEC and its staff, the Release clearly signals that the SEC staff will continue to closely scrutinize these provisions for consistency with their views of the Advisers Act and intend to construe any ambiguity unfavorably for the adviser.

---

27 *See* Adopting Release at n. 202 and accompanying text; Marketing Rule Release at n. 590.

28 GIPS®-compliant Private Fund Advisers will be familiar with this requirement, as GIPS 2020 requires performance both with and without the effect of subscription line if the line is not repaid within 120 days. See GIPS Standards 5.A.2.a., 7.A.2.a. The Quarterly Statement Rule contains no similar de minimis exception.

29 Adopting Release at 258.

30 Adopting Release at 260.

Similarly, the SEC stated in the Adopting Release that it believes that charging a portfolio for services the manager does not expect to provide or (ultimately) provide "generally already runs contrary to an adviser's obligations to its clients under the Federal fiduciary duty."[31] Notwithstanding this guidance, Private Fund Advisers may continue to receive payments in advance for services reasonably expected to be provided in the future, provided that prepaid amounts for unperformed services are refunded.

Advisers should expect these statements from the Adopting Release to resurface in SEC examinations and investigations.

13. If a Private Fund complies with the Custody Rule, does it need to take additional steps to comply with the Audit Rule?

In a change from the Proposal, the Final Rules provide that Private Fund Advisers are required to cause their Private Funds to undergo audits in accordance with the audit provision (and related requirements for delivery of audited financial statements) of the Custody Rule. The SEC made this change to avoid overlapping and different requirements under the Final Rules and the Custody Rule. Consequently, staff guidance on the application of the Custody Rule to Special Purpose Vehicles (**SPVs**)[32] and similar guidance in the Custody Rule FAQs[33] will apply equally to the audit requirement in the Final Rules, as well as the Custody Rule. To the extent that an adviser is already relying on the audit exception in the Custody Rule, it can continue to do so.

By contrast, an adviser that satisfies its obligations under the Custody Rule through surprise examinations will now need to cause managed Private Funds to undergo an audit consistent with the requirements of the Custody Rule. The SEC provided limited relief to advisers that are not in a control relationship with the Private Fund, indicating that such Private Fund Advisers need to take "all reasonable steps" to cause the fund to undergo an audit that meets the requirements set out in the Final Rules.

14. What are some practical impacts of the Adviser-Led Secondaries Rule?

The Final Rules prohibit a Private Fund RIA from conducting an adviser-led secondary transaction unless the adviser meets two conditions. Specifically, prior to the date that the fund investors are required to respond to a written request by the adviser or related person to participate in the transaction, the Private Fund RIA must distribute to investors: (i) an opinion obtained from an independent opinion provider that the price being offered is fair or stating the value, or range of values, of the assets to be sold in connection with the transaction; and (ii) a summary of any material business relationships the Private Fund RIA (or its related persons) has with the independent opinion provider.

Although for many secondaries transactions the Final Rule will not significantly change existing practices, the cost of obtaining an opinion will set a floor for the minimum value of adviser-led secondary transactions. As a

---

31 Adopting Release at 26.

32 Private Funds and Application of the Custody Rule to Special Purpose Vehicles and Escrows, Division of Investment Management Guidance Update No. 2014-07 (June 2014). The Adopting Release also provides that, "an investment adviser could either treat an SPV as a separate client, in which case the adviser will be advising the SPV directly, or treat the SPV's assets as assets of the pooled investment vehicles that it is advising indirectly through the SPV. If the adviser treats the SPV as a separate client, the mandatory Private Fund audit rule will require the adviser to comply with the rule's audited financial statement distribution requirements. Accordingly, the adviser will distribute the SPV's audited financial statements to the pooled investment vehicle's beneficial owners. If, however, the adviser treats the SPV's assets as the pooled investment vehicle's assets that it is advising indirectly, the SPV's assets will be required to be considered within the scope of the pooled investment vehicle's financial statement audit." Adopting Release at 173.

33 Staff Responses to Questions about the Custody Rule (last updated Feb. 21, 2017).

result, the Adviser-Led Secondaries Rule may make certain transactions financially impractical, particularly where the total value of the transaction is relatively low.

The SEC tempered the reach of this rule with guidance on types of types of transactions that would not be covered, which include:

- Cross-trades where investors are not offered a choice to either sell or exchange their interest in the Private Fund.
- "Season and sell" transactions, whereby an entity originates a loan and, after holding the loan for a period for time, sells the loan to an affiliate.
- Rebalancing transactions between parallel funds.
- Tender offers for Private Fund interests where investors are not offered a choice to either sell or exchange their interest in the Private Fund.

15. For purposes of the Restricted Activities Rule, how does an adviser determine that a non-pro rata expense allocation is fair and equitable?

The Final Rules prohibit Private Fund Advisers from charging or allocating fees and expenses related to a Private Fund portfolio investment held by multiple Private Funds and other clients advised by the Private Fund Adviser (or its related persons)[34] on a non-pro rata basis,[35] unless the charge or allocation meets two requirements. First, the non-pro rata allocation must be "fair and equitable" under the circumstances. Second, the Private Fund Adviser must distribute a written notice describing the non-pro rata allocation and how it is fair and equitable under the circumstances before the allocation is made.

The Adopting Release does not provide a framework for how a Private Fund Adviser should determine when a non-pro rata allocation is fair and equitable under the circumstances, but it does provide examples of non-pro rata allocations that may be fair and equitable, including where:

- Expenses relate to a specific type of security held by a private fund client.
- Expenses are associated with setting up a bespoke investment structure for an investor.
- A private fund client is expected to receive a greater benefit from the expense compared to other clients.

Private Fund Advisers also may need to evaluate whether specific situations introduce conflicts of interest between the adviser and clients, or among clients, when multiple Private Funds and other clients invest in the same portfolio investment.[36] The SEC does not provide additional guidance in the Adopting Release as to how a conflict of interest, if identified, should factor into any consideration of whether a non-pro rata allocation is fair and reasonable under the circumstances. However, presumably it would be very difficult to conclude that an allocation that directly or indirectly benefits the adviser or a related person in a disproportionate manner is fair and equitable.

---

[34] Related persons as defined in the rulemaking would include control affiliates, including entities that control, are controlled by or are under common control with the Private Fund Adviser.

[35] The new rule does not define "*pro-rata*". The Adopting Release acknowledged that there could be multiple methods used to determine *pro-rata* allocations. See Adopting Release at 236.

[36] Adopting Release at 236.

The Final Rules do not contain a carve-out for non-pro rata allocations where co-investors participate in a transaction. Although many industry participants have voiced concern that the rule could discourage co-investments, the SEC states in the Adopting Release that it believes the rule "generally" addresses these concerns, noting that the rule's requirements can be completed in time to close a co-investment, and also that there could be scenarios where a non-pro rata allocation could be made in connection with a co-investment.[37] However, as a practical matter, an adviser's obligation to first determine (and document) that an allocation is fair and reasonable and distribute a notice describing the basis for that determination will introduce operational and timing challenges to co-investment transactions that will in turn result in increased execution risk for funds, co-investors and targets.

16. How does an adviser distinguish between a bona fide fund expense and a manager regulatory and compliance expense?

The Final Rules prohibit a Private Fund Adviser from allocating any regulatory or compliance fees or expenses of the adviser or a related person to the Private Fund unless the adviser distributes a written notice of any such fees or expenses,[38] including the amount, to the investors of such Private Fund within 45 days after the end of the fiscal quarter in which the charge or allocation occurs. The Adopting Release provides limited examples of regulatory or compliance expenses, specifically noting: (i) filing and other fees associated with SEC filings, such as Form ADV and Form PF, as well as certain state filings; and (ii) fees and expenses for a compliance consultant to assess the adviser's compliance program, or to assist with mock or real examinations.[39] The SEC opted not to provide additional examples, stating instead, "[a]s we are not flatly prohibiting advisers from passing on compliance, regulatory and examination expenses, we do not believe it is necessary to describe which fees and expenses are related to the adviser's activities or the fund's activities."[40]

Notwithstanding this logic, advisers *will* need to distinguish between fund and manager expenses to determine whether reports are required, and if so, to calculate the amount of manager regulatory and compliance expenses. Broadly speaking, the examples provided by the SEC suggest that an expense related to a legal requirement borne by the adviser (e.g., compliance with the Advisers Act and the rules thereunder) would be considered a legal or compliance fee attributable to the adviser. By contrast, regulatory and compliance expenses that would be incurred in connection with the offering of a fund regardless of the character of its sponsor likely are not manager regulatory and compliance expenses. These may include, *inter alia*, expenses associated with filing Form D, securing offering exemptions in non-U.S. jurisdictions and tax compliance.

However, due to the SEC's intentional ambiguity on this point, Private Fund Advisers will continue to face uncertainty with respect to many expenses, and in particular shared expenses. Advisers will likely be best positioned by either disclosing any expenses that are shared obligations of the adviser or a related party and the fund (e.g., ensuring that offering materials that are also advertisements comply with the Marketing Rule), or maintaining documentation to support why they take the position that a particular fee is not a regulatory or compliance expense of the adviser or a related person.

---

37 Adopting Release at 234-35.

38 With respect to this requirement, the Adopting Release indicates that, "Such a written notice should generally include a detailed accounting of each category of such fees and expenses. Advisers should generally list each specific category of fee or expense as a separate line item and the dollar amount thereof, rather than group such fees and expenses into broad categories such as "'compliance expenses.'" Adopting Release at note 630. It goes on to say that if an adviser charges a fund for fees and expenses associated with the preparation and filing of the adviser's Form ADV, it should not list this expense as "legal expenses." Adopting Release at n. 642.

39 Adopting Release at 214-17

40 Adopting Release at 217.

This update was authored by:

David P. Bartels
Partner
Washington, D.C.
+1 202 261 3375
david.bartels@dechert.com

Sonia R. Gioseffi
Partner
San Francisco
+1 415 262 4504
sonia.gioseffi@dechert.com

Michael W. McGrath
Partner
Boston
+1 617 728 7178
michael.mcgrath@dechert.com

Jennifer A. DiNuccio
Associate
Boston
+1 617 728 7187
jennifer.dinuccio@dechert.com

Phillip Garber
Associate
San Francisco
+1 415 262 4554
phillip.garber@dechert.com

Lindsay R. Grossman
Associate
Boston
+1 617 728 7183
lindsay.grossman@dechert.com

Derek Manners
Associate
Washington, D.C.
+1 202 261 7759
derek.manners@dechert.com

Michael Murphy
Associate
Boston
+1 617 728 7155
michael.murphy@dechert.com