

# U.S. SEC Adopts Significant Changes for Advisers and Private Funds

August 24, 2023

Yesterday the U.S. Securities and Exchange Commission (Commission), in a 3-2 vote, adopted sweeping changes to allowable practices, reporting, and disclosure aimed primarily at advisers to private funds<sup>1</sup> (the [Private Funds Rules](#)). These new rules under the Investment Advisers Act of 1940 (the Advisers Act) affect investment advisers differently depending on their registration status and location, the type of client advised, the investments held in the applicable private funds, and the types of relationships with private fund clients and investors. Notably, the Private Funds Rules do not apply to advisers' securitized asset funds (as defined in Form PF and Form ADV). The new Private Funds Rules include

- restrictions on business practices and on “preferential treatment” by any advisers to private funds, not just advisers registered or required to be registered (including both U.S. and non-U.S. exempt reporting advisers (ERAs) and others)
- requirements for fairness or valuation opinions for adviser-led secondaries by registered private fund advisers (not by ERAs or other advisers not registered with the SEC)
- requirements for quarterly statements and annual audits for private fund clients of registered advisers (not of ERAs or other advisers not registered with the SEC)

The Commission provided for a staggered set of compliance dates for the new rules (see the compliance table at the end of this Client Update). The Commission also provided an [overview](#) of the new requirements to supplement the adopting release for the Private Funds Rules.

## Our Take

The much anticipated and hotly debated Private Funds Rules were approved by the Commission over the strong and vocal objection of some Commissioners. Commissioner Hester M. Peirce opened her [statement](#) on the Private Funds Rules by characterizing the rulemaking as “ahistorical, unjustified, unlawful, impractical, confusing and harmful,” while Commissioner Mark Uyeda labeled the Private Fund Rules “arbitrary and [capricious](#).” All five Commissioners took turns either defending the Commission’s authority to adopt the Private Funds Rules or questioning the authority under which the Commission was acting, with Chair Gary Gensler asserting that the Private Fund Rules “[will promote private fund advisers’ efficiency, competition, integrity, and transparency](#)” and pausing after all of the statements and before the final vote to reiterate his view that the Commission has sufficient authority to promulgate the Private Funds Rules. These arguments presumably will be among the points raised if the Private Funds Rules are challenged.

Substantively, the Private Funds Rules are very similar to the rules that the Commission proposed over a year and a half ago. While this means that the Commission did not take action on many of the industry comments highlighting the negative impacts of the proposed rules, the Private Funds Rules, as adopted, do contain some changes addressing some of the more significant concerns raised by private fund sponsors and investors.

First, the Private Funds Rules do not apply to securitized asset funds. The Commission accepted industry feedback on the many challenges securitized asset funds faced to comply with the proposed rules. The Commission outlined many ways either that securitized asset funds would not have been able practically

to comply with the Private Funds Rules or that the Commission's policy objectives are already met through the typical structure, operations, and investor reporting for securitized asset funds.

Second, the Commission dropped its proposed prohibition on an adviser seeking reimbursement, indemnification, exculpation, or limitation of its liability to a private fund for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness. The Commission asserted that most of the activities they sought to prohibit are "already prohibited by the Federal fiduciary duty and antifraud provisions." The Commission clarified its view on the application of the fiduciary duty to private fund clients, setting forth examples and discussing the use of a savings clause. Staff of the Division of Investment Management confirmed, in response to questions from the Commissioners, that the Private Funds Rules are not intended to expand or modify the [Commission's 2019 Interpretation Regarding Standard of Conduct for Investment Advisers](#).

Third, the Commission modified its approach to prohibited activities (now known as "restricted activities") and preferential treatment under the Private Funds Rules, creating four tiers of restrictions:

- (i) activities that are outright prohibited (the payment by private funds of expenses related to an investigation that results in an imposed sanction for a violation of the Advisers Act and most preferential liquidity and information rights)
- (ii) activities that are restricted but can be undertaken with subsequent notice (payment by private funds of other compliance, regulatory, and examination costs; reduction of a clawback to reflect taxes; and preferential treatment not relating to liquidity and information)
- (iii) activities that are restricted but can be undertaken with prior notice and specific disclosures (non-pro-rata allocation of fees and expenses for portfolio investments (or potential investments) and, for prospective investors, preferential treatment of material economic terms not relating to liquidity and information)
- (iv) activities that are restricted but can be undertaken with disclosure *and* prior written consent (payment of costs relating to investigations (except where Advisers Act sanctions are levied) and adviser borrowing from a private fund)

To be sure, some advisers will view these limitations and restrictions as effectively prohibiting these activities. Nonetheless, by recasting "prohibitions" into "limitations and restrictions," the Commission provided potential alternatives, albeit limited.

Finally, both the restricted activities provisions in (ii)–(iv) above and the preferential treatment provision (exclusive of the disclosure requirements) contain grandfathering provisions (now known as "legacy status" provisions). It appears that the Commission acknowledged and addressed the enormous burdens and challenges that the Private Fund Rules would impose on the tens of thousands of private funds operating under governing documents and agreements that permitted and disclosed conflicts for activities the Commission proposed to prohibit. Recognizing the limitations of the original proposal, the Commission revised the restricted activities and preferential treatment rules to exempt private funds with preexisting arrangements from the new requirements if compliance with those rules would require them to update fund governing documents or agreements. The legacy status provisions apply only with respect to existing agreements with parties as of the compliance date.

Even with these modifications, the Private Funds Rules represent a seismic shift in the regulation of private funds. Advisers face operational challenges as they strive to comply with new substantive requirements and compliance deadlines, which will require significant efforts to overcome. While the Commission clarified the scope of some reporting requirements and timeframes, the Private Fund Rules mostly left intact the reporting and classification requirements contained in the proposal.

## The Private Funds Rules — New Requirements for Private Fund Advisers

The requirements of the Private Funds Rules and related amendments, the advisers that would be affected by the changes, and a comparison to the rules proposed by the Commission are outlined in the table below.

| <b>Rule 211(h)(2)-1: Restricted Activities (proposed as “Prohibited Activities”)</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Proposed</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | <b>Adopted</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| <b>Advisers Affected</b> — Any investment adviser (registered or exempt)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| <p>The Commission proposed to prohibit the following practices for all private fund advisers:</p> <ul style="list-style-type: none"> <li>• <i>Fees for Nonperformed or Underperformed Services</i>: Charging for monitoring, servicing, consulting, or other services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment (sometimes referred to as “accelerated payments”). Would not prohibit an adviser from receiving payments in advance for services that it reasonably expects to provide in the future.</li> <li>• <i>Limiting or Eliminating Liability for Adviser Misconduct</i>: Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness would be prohibited.</li> <li>• <i>Certain Fees and Expenses</i>: Charging fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority as well as regulatory and compliance fees and expenses of the adviser or its related persons. Regulatory, compliance, and filing fees directly related to the activities of the private fund would still be permitted.</li> <li>• <i>Borrowing</i>: Borrowing or receiving a loan from a private fund client would have been prohibited.</li> <li>• <i>Reducing Adviser Clawbacks for Taxes</i>: Reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders would be prohibited.</li> </ul> | <p>The Commission eliminated some prohibitions and recast others as restrictions or limitations, subject to prior notice alone or prior notice and consent. The restrictions or limitations do not apply to securitized asset funds.</p> <p><i>Removed from the Rule</i>: The Commission did not draft the Rule to prohibit</p> <ul style="list-style-type: none"> <li>• <i>Fees for Non-performed or Underperformed Services</i></li> <li>• <i>Limiting or Eliminating Liability for Adviser Misconduct</i></li> </ul> <p>In each case, however, the Commission suggested that such practices did not require prohibition because they raised fiduciary (and/or fraud) issues.</p> <p>Prior Written Consent Required:</p> <ul style="list-style-type: none"> <li>• <i>Certain Fees and Expenses</i>: Unlike the proposal, the final rule does not prohibit certain fees and expenses associated with an investigation of the adviser by any governmental or regulatory authority. Rather, to charge these fees and expenses, an adviser must request the consent of each private fund investor and obtain written consent from at least a majority in interest of the private fund’s investors that are not related persons prior to charging or allocating fees or expenses.</li> </ul> <p>However, an adviser may not charge or allocate to a private fund fees or expenses related to a sanction for a violation of the Investment Advisers Act of 1940 or its rules.</p> |

- ***Certain Non-Pro-Rata Fee and Expense Allocations:*** Charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro-rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment would be prohibited.

- ***Borrowing:*** Unlike the proposal, the final rule does not prohibit certain borrowing activities. Rather, advisers can borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client only if the adviser (i) distributes to each investor a written description of the material terms of, and requests each investor to consent to, such borrowing, loan, or extension of credit and (ii) obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser.

Notably, ordinary course tax advances and management fee offsets are not considered borrowings for purposes of the Rule.

***Written Notice Required Within 45 Days of Quarter End:*** Unlike the proposal, the final rule does not prohibit certain expenses. The final rule restricts the following activities unless the adviser distributes written notice to investors within 45 days of the end of the fiscal quarter in which the expense was incurred or clawback occurred.

- ***Reducing Adviser Clawbacks for Taxes*** — must disclose the aggregate dollar amounts of the adviser clawback before and after any reduction for actual, potential, or hypothetical taxes
- ***Regulatory or Compliance Fees or Fees Associated With an Examination*** — must disclose the specific dollar amount of the fees or expenses incurred

Prior Written Notice Required:

- ***Non-Pro-Rata Fee and Expense Allocations:*** Advisers may not make non-pro-rata fee or expense allocations relating to a portfolio investment (or proposed investment) unless (i) the non-pro-rata charge or allocation is fair and equitable under the circumstances, and (ii) *prior* to charging or allocating such fees 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 how it is fair and equitable under the circumstances.

|  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|--|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  | <p><b>Legacy Status:</b> The Restricted Activities under Rule 211(h)(2)-1(a)(1), fees and expenses of an investigation of the adviser by a governmental or regulatory authority, and Rule 211(h)(2)-1 (a)(5), borrowing, shall not apply to a private fund that has commenced operations as of the compliance date and if compliance would require the private fund to amend governing agreements.</p> <p>However, the Legacy Status provision (Rule 211(h)(2)-1(b)) will not apply to any private fund fees or expenses related to a sanction for a violation of the Advisers Act or its rules.</p> |
|--|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

| <b>Rule 211(h)(2)-3: Preferential Treatment Rule</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Proposed</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | <b>Adopted</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| <b>Advisers Affected — Any investment adviser (registered or exempt)</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <p>Would prohibit certain types of preferential treatment by any private fund adviser — whether registered or not — that the Commission has deemed to “have a material negative effect on other investors.”</p> <ul style="list-style-type: none"> <li>• Would prohibit private fund advisers from providing <ul style="list-style-type: none"> <li>(i) preferential terms to certain investors regarding redemptions or information about portfolio holdings or exposures</li> <li>(ii) any other preferential treatment to any investor in the private fund <b>unless</b> the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund</li> </ul> </li> </ul> <p>Would prohibit, without exception, any right granted to an investor in the fund or a substantially similar pool of assets managed by the adviser or its related persons “to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors,” even if, for example, the investor could no longer legally hold the investment.</p> <p>Preferential terms or the preferential sharing of other information would be prohibited without advance written disclosure to current and prospective investors. Advisers would be required</p> | <p>As adopted, the Preferential Treatment Rule</p> <ul style="list-style-type: none"> <li>• prohibits advisers from providing preferential treatment to investors in a private fund or similar pool of assets with respect to either redemption rights or information with respect to portfolio holdings or exposure, where the adviser reasonably expects that such preferential treatment would have a material, negative effect on other investors</li> <li>• requires disclosure of all other types of preferential treatment</li> </ul> <p><b>Preferential Redemption Rights:</b> In a change from the proposal, the Preferential Treatment Rule includes two exceptions from the redemption prohibition;</p> <ul style="list-style-type: none"> <li>• redemptions required by applicable law, rule, regulation, or order of certain governmental authorities (but not for more for more informal redemption arrangements, such as those dictated by internal policies or resolutions)</li> <li>• when the adviser has offered the same redemption rights to all existing investors and will continue to offer the same redemption rights to all future investors in the private fund or similar pool of assets</li> </ul> <p>Preferential Information Rights About Portfolio Holdings or Exposures:</p> <p>The Preferential Treatment rule includes an</p> |

|                                                                                                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>to describe with specificity the preferential treatment and its relevance and provide disclosure to prospective investors prior to the investors making an investment. The adviser would be required to distribute an annual notice to all current investors with the details of any preferential treatment provided to any investor since the last annual notice provided to investors.</p> | <p>exception when the adviser offers information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time.</p> <p>Disclosure Requirement:</p> <ul style="list-style-type: none"> <li>• For current investors, advisers must provide comprehensive, written, annual disclosure of all preferential treatment provided by the adviser or its related persons since the last annual notice.</li> <li>• In a change from the proposal, the Preferential Treatment Rule requires the adviser to distribute to current investors the required written notice of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund; <ul style="list-style-type: none"> <li>○ for an illiquid fund, as soon as reasonably practicable following the end of the fund's fundraising period</li> <li>○ for a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund</li> </ul> </li> <li>• For prospective investors, advisers are required to provide only "material economic terms."</li> <li>• Disclosure obligations extend to all preferential treatment, including any preferential treatment granted in accordance with the exceptions set forth in final rule 211(h)(2)-3(a).</li> </ul> <p><i>"Similar Pools of Assets":</i> The SEC changed the defined term "substantially similar pool of assets" to "similar pool of assets" throughout the Preferential Treatment Rule as adopted "so that the term better reflects the breadth of the definition."</p> <p><i>Legacy Status:</i> The limitations on preferential redemption rights and performance and exposure information do not apply to any private fund that commenced operations as of the compliance date and for which compliance would require amending the private funds governing agreements.</p> |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

| <b>Rule 211(h)(1)-2: Quarterly Statement Rule</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Proposed</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | <b>Adopted</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| <b>Advisers Affected</b> — Investment advisers registered with the SEC <sup>2</sup>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| <p>Would require a registered investment adviser to provide quarterly statements detailing fees, expenses, and performance to the investors in any private fund that it advises.</p> <p>The Quarterly Statement Rule would require private fund advisers to</p> <ul style="list-style-type: none"> <li>• deliver to investors quarterly statements with required minimum disclosures</li> <li>• prepare a “Fund Table” detailing adviser compensation with separate line items for each category of allocation or payment, fees, and expenses. The table includes fees and expenses paid by underlying portfolio investments to the adviser or its related persons and any offsets or rebates (as well as the amount of any offsets or rebates carried forward)</li> <li>• provide details concerning what is considered adequate disclosure at private-fund level and portfolio-investment level. Advisers are required to “list each specific category of expense as a separate line item, rather than permit advisers to group expenses into broad categories”; additional details disclosed in the table would include any compensation paid to the adviser or an affiliate by a portfolio investment (both before and after any offsets, rebates, or waivers) along with the ownership percentage held by the fund of any portfolio investment that paid compensation to the adviser</li> </ul> <p>The quarterly statement must include disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated, including “cross references to the relevant section of the private fund’s organizational and offering documents that set forth the calculation methodology.”</p> <p>The Quarterly Statement Rule would require private fund advisers to include standardized fund performance information in each quarterly statement provided to fund investors for each portfolio investment (defined as any entity in which the private fund has invested directly or indirectly).</p> | <p>The Quarterly Statement Rule was adopted substantially as proposed.</p> <p>Advisers will be required to prepare and distribute to investors a quarterly statement that includes certain, detailed information regarding fees, expenses, and performance for any private fund that it advises.</p> <p>Fee and Expense Disclosure (Private Fund Level and Portfolio Investment-Level Disclosure):</p> <p>The Rule requires disclosure of the fund’s fees and expenses and any compensation paid or allocated to the adviser or its related persons by the fund as well as any compensation paid or allocated by the fund’s underlying portfolio investments.</p> <p>Changes From the Proposal:</p> <ul style="list-style-type: none"> <li>• The fee and expense disclosure obligation captures fees paid or “allocated to” the adviser and fees/expenses “allocated to” or paid by the fund.</li> <li>• The definition of “performance-based compensation” was slightly revised to include “and profit,” underscoring the broad nature of the definition.</li> <li>• Performance-based compensation includes compensation to a related person that is a subadviser to the private fund, to the extent that the compensation to the related person is allocated or paid by the fund.</li> </ul> <p>Performance Disclosure:</p> <p>The Rule requires advisers to include standardized fund performance information in each quarterly statement. Different, specific disclosure is required for liquid funds and illiquid funds.</p> <ul style="list-style-type: none"> <li>• For liquid funds, the statement will include annual net total returns since inception, average annual net total returns over prescribed time periods, and quarterly net total returns for the current calendar year.</li> </ul> |

|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>An adviser would be required to consolidate reporting for substantially similar pools of assets to the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading. In the instance of a master-feeder fund structure, the adviser would have been required "to provide feeder fund investors with a single quarterly statement covering the applicable feeder fund and the feeder fund's proportionate interest in the master fund on a consolidated basis."</p> | <ul style="list-style-type: none"> <li>• For illiquid funds, the statement will include the gross and net internal rate of return (IRR) and gross and net multiple of invested capital (MOIC) of the illiquid fund and the gross IRR and MOIC of the realized and unrealized portions of the portfolio separately, all computed with and without the impact of fund-level subscription facilities (potentially, 16 calculations). The rule requires an adviser to disclose the illiquid fund's performance measures since inception.</li> </ul> <p>Removed From the Rule:</p> <p>The portfolio-level investment table no longer requires disclosure of a private fund's ownership percentage of a covered portfolio investment.</p> <p>Changes from the Proposal:</p> <ul style="list-style-type: none"> <li>• Definition of illiquid fund is a private fund that (i) is not required to redeem interests upon an investor's request and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund.</li> <li>• The performance reporting period for annual net total returns (liquid funds) is now 10 years.</li> <li>• The illiquid fund reporting requirement was revised such that an adviser is required to disclose performance figures with and without the impact of fund-level subscription facilities.</li> </ul> <p>Clarifications:</p> <ul style="list-style-type: none"> <li>• Portfolio investment compensation does not include dividends.</li> <li>• Performance-based compensation includes compensation to a related person that is a subadviser to the private fund, to the extent that the compensation to the related person is allocated or paid by the fund.</li> </ul> <p>Consolidated Reporting for Certain Fund Structures:</p> <p>Adopted as proposed. An adviser generally is required to consolidate reporting for similar pools of assets.</p> |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

|  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|--|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  | <p><b>Format and Content Requirements:</b></p> <p>While the rule clearly prescribes the content of the quarterly statements, the rule takes a principles-based approach to the formatting of such information in a table.</p> <p>The Release underscored that there is not a <i>de minimis</i> exception for disclosure of compensation or expenses in the Fund Table. “Miscellaneous” or catchall categories are not permitted.</p> <p><b>Change From the Proposal on the Delivery Timeline:</b></p> <p>The delivery timeline was extended slightly. The deadline to distribute the statements was extended. Funds (other than fund of funds) must distribute the statements within 45 days after the first three fiscal quarter ends of each fiscal year and 90 days after fiscal year end. Fund of funds must deliver statements 75 days after quarter end and 120 days after fiscal year end.</p> |
|--|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

| <b>Rule 206(4)-10: Private Fund Audit Requirement</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Proposed</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | <b>Adopted</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| <b>Advisers Affected —</b> Investment advisers registered with the SEC                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| <p>Would require registered advisers to cause each private fund they advise to undergo an annual financial statement audit.</p> <p>The audit would have been required to meet the following:</p> <ul style="list-style-type: none"> <li>• <i>Requirements for Accountants:</i> The accountant performing a private fund audit would have been required to (i) meet the standards of independence and (ii) be registered with, and subject to, regular inspection as of the commencement of the professional engagement period, and as of each calendar year end, by the Public Company Accounting Oversight Board in accordance with its rules.</li> <li>• <i>Auditing and Preparation Standards:</i> Audited financial statements would have been required to be performed and prepared in accordance with generally accepted accounting principles (GAAP) or, if under non-</li> </ul> | <p>An adviser is required under Rule 206(4)-10 to cause each private fund it advises to undergo an annual financial statement audit. The rule provides an exception from the audit requirement for securitized asset funds.</p> <p>The requirements for accountants, auditing and preparation standards, and distribution requirements have been replaced by explicit reference to substantially similar requirements of the audit exemption for pooled investment vehicles contained in the Custody Rule under the Advisers Act (Rule 206(4)-2(b)(4)(i)-(iii)).</p> <p>The private fund audit rule will prohibit any adviser from providing advisory services (including as a subadviser) to a private fund that it does not control (and is neither controlled by nor under common control with the adviser) if the adviser fails to take all reasonable steps to cause the private fund to undergo a financial statement audit that meets the</p> |

|                                                                                                                                                                                                                                                         |                                                                                         |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------|
| <p>U.S. law, a standard similar to GAAP.</p> <p><i>Prompt Distribution:</i> Advisers would have been required to distribute audited financial statements to current investors “promptly” after the completion of the audit; no prescribed deadline.</p> | <p>requirements of the Custody Rule audit exemption (Rule 206(4)-2(b)(4)(i)-(iii)).</p> |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------|

| <b>Rule 211(h)(2)-2: Adviser-Led Secondary Rule</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Proposed</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | <b>Adopted</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| <b>Advisers Affected</b> — Investment advisers registered with the SEC                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <p>Would have required a registered adviser to a private fund to distribute to fund investors, prior to completing an adviser-led secondary transaction, (i) a fairness opinion from an independent opinion provider and (ii) a written summary of any material business relationships the adviser (or any of its related persons) has, or has had, within the past two years with the independent opinion provider.</p> <p>Would have required the adviser to retain a copy of the fairness opinion and the material business relationship summary distributed to its fund investors as well as a record of each addressee, the date(s) the opinion was sent, and the delivery method.</p> | <p>The Rule requires a registered adviser to a private fund to distribute to fund investors (including investors in feeder funds that the adviser controls) in connection with an adviser-led secondary (i) a fairness opinion or a valuation opinion from an independent opinion provider and (ii) a written summary of any material business relationships the adviser (or any of its related persons) has, or has had, within the past two years with the independent opinion provider. The fairness/valuation opinion and the material business relationship summary need to be distributed prior to the due date of the election form in respect of the adviser-led secondary transaction.</p> <p>The Rule requires the adviser to retain a copy of the fairness opinion and the material business relationship summary distributed to its fund investors as well as a record of each addressee and the date(s) the opinion and summary were sent (but not the addresses nor the delivery method).</p> <p>The Rule defines an adviser-led secondary transaction as a transaction initiated by the adviser or any of its related persons that offers private fund investors the choice between (a) selling all or a portion of their interests in the private fund <i>and</i> (b) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. The definition would not capture limited partner tenders or other transactions in which the investor has the option to stay in the existing vehicle under the same terms. The fairness/valuation opinion does not need to opine on the terms of the transaction, and it is not required that investors can rely on it.</p> |

| <b>Compliance Dates</b>                    |                                                                                                                                                                                     |                                                                                                        |
|--------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------|
| <b>Rule</b>                                | <b>Larger Private Fund Advisers (\$1.5 billion or more of private fund assets under management)</b>                                                                                 | <b>Smaller Private Fund Advisers (less than \$1.5 billion of private fund assets under management)</b> |
| 204-2 —Books and Records                   | 12 to 18 months after date of publication in the <i>Federal Register</i> in conjunction with the underlying Rules 206(4)-10, 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, and 211(h)(2)-3 | 18 months after date of publication in the <i>Federal Register</i>                                     |
| 206(4)-10 — Private Fund Audit Requirement | 18 months after date of publication in the <i>Federal Register</i>                                                                                                                  | 18 months after date of publication in the <i>Federal Register</i>                                     |
| 211(h)(1)-2 — Quarterly Statement Rule     | 18 months after date of publication in the <i>Federal Register</i>                                                                                                                  | 18 months after date of publication in the <i>Federal Register</i>                                     |
| 211(h)(2)-1 — Restricted Activities        | 12 months after date of publication in the <i>Federal Register</i>                                                                                                                  | 18 months after date of publication in the <i>Federal Register</i>                                     |
| 211(h)(2)-2 — Adviser-Led Secondary Rule   | 12 months after date of publication in the <i>Federal Register</i>                                                                                                                  | 18 months after date of publication in the <i>Federal Register</i>                                     |
| 211(h)(2)-3 — Preferential Treatment Rule  | 12 months after date of publication in the <i>Federal Register</i>                                                                                                                  | 18 months after date of publication in the <i>Federal Register</i>                                     |

## Conclusion and Next Steps

The five new rules that make up the Private Funds Rules will require substantial adjustments particularly to accommodate the new quarterly reporting requirements. We anticipate that many advisers will need to incorporate changes throughout their existing businesses to address these new rules and be appropriately prepared for the various compliance dates. Policy updates and modifications as well as operational changes may be necessary to address these new requirements. Challenges to these Private Funds Rules could cause the compliance dates to be delayed. But the outcome of a challenge, if any, will not be known for a while. Therefore, advisers should begin the process of assessing the impact to their businesses well ahead of the compliance dates.

---

<sup>1</sup> Private funds are funds that rely on the exclusions in Sections 3(c)(1) or (7) of the Investment Company Act of 1940.

<sup>2</sup> Each of the three rules that apply to non-U.S. advisers registered with the SEC is a substantive rule that the Commission has said will not apply with respect to non-U.S. private fund clients even if they have U.S. investors.

## CONTACTS

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, a member of our [Investment Funds practice](#) or [Securities Regulatory](#) team, or one of our practice leaders listed below:

|                                       |                                                                                       |
|---------------------------------------|---------------------------------------------------------------------------------------|
| <b>Chuck Daly</b> , Counsel           | +1 212 839 6727, <a href="mailto:charles.daly@sidley.com">charles.daly@sidley.com</a> |
| <b>Elizabeth Shea Fries</b> , Partner | +1 617 223 0388, <a href="mailto:efries@sidley.com">efries@sidley.com</a>             |
| <b>Stephen L. Cohen</b> , Partner     | +1 202 736 8682, <a href="mailto:scohen@sidley.com">scohen@sidley.com</a>             |

---

Sidley Austin LLP provides this information as a service to clients and other friends for educational purposes only. It should not be construed or relied on as legal advice or to create a lawyer-client relationship. Readers should not act upon this information without seeking advice from professional advisers.

Attorney Advertising—Sidley Austin LLP, One South Dearborn, Chicago, IL 60603. +1 312 853 7000. Sidley and Sidley Austin refer to Sidley Austin LLP and affiliated partnerships, as explained at [www.sidley.com/disclaimer](http://www.sidley.com/disclaimer).

© Sidley Austin LLP