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The New Private Fund Rules: What Now for VC Fund Advisers and Other ERAs?



As we reported in our recent blog post, "[SEC Imposes New Burdens on Registered and Exempt Private Fund Advisers](#)," the U.S. Securities and Exchange Commission (the SEC) has adopted significant new rules<sup>[1]</sup> under the Investment Advisers Act of 1940 (the Advisers Act) that apply to the investment advisers of private funds.<sup>[2]</sup>

Some of the new rules apply to all private fund advisers, including venture capital fund advisers (VC Fund Advisers) and other exempt reporting advisers (ERAs),<sup>[3]</sup> while others apply only to SEC-registered private fund advisers (RIAs).

Please see our **cheat sheet** (attached here as [Appendix A](#)) that answers basic questions about the new rules and their application to VC Fund Advisers, ERAs, and RIAs.

Below, we delve into the two new Advisers Act rules that apply to VC Fund Advisers and other ERAs and offer steps that they should take sooner rather than later to begin the compliance implementation process.

### **The Restricted Activities Rule<sup>[4]</sup>**

***Five Potentially Harmful Practices.*** New Rule 211(h)(2)-1 under the Advisers Act (the Restricted Activities Rule) is intended to address five practices that the SEC believes are potentially harmful to investors because investors are not capable of judging the impact of the practices and even limited partner advisory committees (LPACs) are not always able to effectively oversee them. These restricted activities include:

1. Causing a private fund to pay fees and expenses associated with an investigation of the adviser without prior written consent.
2. Causing a private fund to pay for regulatory, examination, or compliance fees or expenses of the adviser without specific disclosures.

3. Reducing the amount of the adviser's carried interest clawback by the amount of the adviser's taxes without specific disclosures.
4. Allocating or charging fees or expenses related to portfolio investment shared among multiple private funds and/or related persons without advance written notice of the non-pro rata [charge](#) and a description of how the adviser believes it is fair and equitable.
5. Borrowing money or securities from a private fund without sufficient disclosure and written consent.

The SEC explains in the Adopting Release its view that, disclosure/consent is necessary to allow these practices because they "involve conflicts of interest (e.g., borrowing directly from a private fund client may benefit the adviser while not being in the best interest of the fund) and compensation schemes (e.g., passing certain expenses on to funds, which increases the adviser's revenue and decreases the fund's profits) that are contrary to the public interest and the protection of investors" against "fraud and deception." The SEC notes that its "concerns with these activities have persisted despite . . . related enforcement actions."

**Disclosure/Consent: A Path to Permissibility.** Looking closely, the restricted activities fall into two buckets: (1) those that are permissible only if an adviser "distributes" [\[5\]](#) disclosure *and* obtains written consent; (2) and those that only require the distribution of disclosure. The SEC's reasoning is that investors may "benefi[t] from these activities when they are carried out in the best interests of the fund, if . . . provided with disclosures and, in some cases, consent rights."

Where the Restricted Activities Rule requires written consent, advisers must try to obtain consent from all of a private fund's investors and must secure consent from at least a majority in interest of outside investors. Importantly, a private fund's LPAC, advisory board, board of directors, or similar governing body cannot consent to these practices; rather, consent must be provided by the individual investors.[\[6\]](#)

And it gets more complicated. As set forth in the table and associated notes below, in certain cases, the disclosure must be made, and consent obtained, prior to the adviser engaging in the "restricted" activity, while in others, the adviser must provide "after-the-fact" disclosures. Certain limits apply, and certain disclosures must address specific points. A bevy of statutory definitions apply. And as discussed in greater detail below, "legacy status" treatment is available under certain circumstances.

	Advance Disclosure	Subsequent Disclosure <a href="#">[7]</a>	Consent	Legacy Status Option
1. Adviser investigation expenses <a href="#">[8]</a>	X		X	X
2. Adviser regulatory, examination, or compliance fees		X <a href="#">[9]</a>		
3. Adviser post-tax clawbacks <a href="#">[10]</a>		X <a href="#">[11]</a>		
4. Non-pro rata allocations	X <a href="#">[12]</a>			
5. Borrowing from fund clients <a href="#">[13]</a>	X		X	X

**Legacy Status: Grandfathering Certain Restricted Activities.** The Restricted Activities Rule with respect to adviser investigation costs and borrowings does not apply to existing funds and their contractual agreements, except that "legacy status" is not available for fees or expenses related to an investigation that results in Advisers Act sanctions for the adviser. Where available, legacy status applies to agreements entered into prior to the compliance date of the Restricted Activities Rule by private funds that had commenced operations as of that date.[\[14\]](#)

**Steps Toward Implementation: Begin Now.** Although the compliance date for the new rules is approximately a year and a half out, VC Fund Advisers and other ERAs should begin now working with counsel to assess the extent to which their operations, contracts (including fund offering documents), and policies and procedures are affected by the new rules.

- One phase of implementation will likely involve identifying and memorializing existing arrangements that can be grandfathered under the legacy status provisions of the new rules.
- Another phase will be determining whether to take advantage of any of the disclosure/consent exceptions and if so, preparing standard disclosure and consent forms and related procedures.
- Still another will entail reviewing protocols, contracts (including fund offering documents), and policies and procedures for any necessary updates.

It will be important for VC Fund Advisers and other ERAs to document their compliance with the disclosure and consent requirements of the Restricted Activities Rule by maintaining records of the disclosure, consent and other documents distributed in accordance with the rule.

*The compliance deadline for the Restricted Activities Rule for firms with ? \$1.5 billion in private fund assets is 12 months from publication of the new rules in Federal Register, and 18 months for firms with < \$1.5 billion.*

## **The Preferential Treatment Rule**[\[15\]](#)

**Strict Limits on Redemption and Information Rights.** New Rule 211(h)(2)-3 under the Advisers Act (the Preferential Treatment Rule) is intended to address SEC concerns about side letters and other arrangements that benefit some investors at the expense of others. Advisers, the SEC also worries, have incentives to provide more favorable rights to larger investors and those that offer financial or other benefits to the adviser. The Preferential Treatment Rule prohibits an adviser from, directly or indirectly, granting:

- *Favorable redemption or liquidity rights* to an investor in a private fund or in a "substantially similar pool of assets"[\[16\]](#) if the adviser "reasonably expects"[\[17\]](#) the preferential rights to have a "material, negative effect"[\[18\]](#) on other investors in the fund or substantially similar pool of assets, *unless* (1) the redemption rights are required by the applicable laws, rules, regulations or orders of any relevant government[\[19\]](#) or (2) the adviser offers the same redemption rights to *all* existing and future investors in the private fund or similar pool of assets *without qualification*[\[20\]](#) as to commitment size, affiliation or other factors.
- *Favorable portfolio holdings and exposure information rights* to an investor in a private fund or a substantially similar pool of assets if the adviser reasonably expects the information would have a material, negative effect on other investors in the fund or substantially similar pool of assets, *unless* the adviser offers, at the same time or substantially the same time, the same information to all existing investors in the private fund or similar pool of assets and will continue to do so with future investors.

The above prohibitions apply to direct and indirect preferential rights and even if a related person of the private fund or the adviser grants the rights, not the adviser or fund itself. They are intended to be broad in scope and designed to prevent advisers from structuring around them.

The SEC emphasizes in the Adopting Release that "selective disclosure to certain parties is a fundamental concern often prohibited or restricted under other Federal securities laws" and that the Preferential Treatment Rule is designed to mitigate attempts by advisers to treat portfolio holdings information as a "commodity" that can be used to gain or maintain favors with certain investors. Specifically, the SEC is concerned about scenarios in which investors with preferential information rights are able to front run other investors, noting that "the ability to redeem is an important part of determining whether providing information would have material,

negative effect on other investors." Of course, the risk of preferential redemption (a material, negative effect on other investors) is not generally present in illiquid/closed-end private funds, like venture capital funds, where redemptions in the ordinary course are not allowed. The SEC acknowledges this, but insists that based on the facts and circumstances, including the adviser's reasonable expectations in providing any preferential redemption rights to an illiquid fund's investors, a material, negative impact on other investors could be found.

**Legacy Status: Grandfathering Redemption and Information Rights.** The Preferential Treatment Rule with respect to redemption and information rights does not apply to agreements entered into prior to the compliance date of the Preferential Treatment Rule by private funds that had commenced operations as of that date.

**Transparency on Preferential Treatment.** The Preferential Treatment Rule establishes that VC Fund Advisers and other ERAs may not, directly or indirectly, provide any preferential treatment to any private fund investor unless the adviser provides certain disclosures, as described below.

The SEC believes that increased transparency in this regard "will better inform investors about the breadth of preferential treatment, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms . . . help investors understand whether, and how, such terms present conflicts of interest or otherwise impact the adviser's compensation schemes with the private fund . . . [and] also help prevent investors from being potentially defrauded or deceived by preferential treatment that negatively impacts their investment in the private fund." The SEC also expects this sunlight to aid investors in learning "whether other investors are receiving a better or different deal and whether any such arrangements pose potential conflicts of interest, potential harms, or other disadvantages (e.g., to the extent other investors are excused from participating in certain types of investments, such as alcohol-related investments, the participating investors may become over concentrated in such investments)."

- The Preferential Treatment Rule requires that written disclosure be distributed to prospective private fund investors, in advance of their investment, regarding *any preferential treatment related to any material economic terms* that the adviser and/or its related persons provide to other investors in the same fund. Material economic terms must be described in detail and include, but are not limited to, those related to the cost of investing, liquidity rights, fee breaks, and co-investment rights.
- The Preferential Treatment Rule requires that written disclosure be distributed regarding *all other preferential terms* that the adviser and/or its related persons provide to other investors in the same fund:
  - To current investors in an illiquid fund as soon as reasonably practicable after the end of the fundraising period and to current investors in a liquid fund as soon as reasonably practicable following their initial and any subsequent investment in the fund.
  - To all private fund investors and any underlying fund of fund investors at least annually.[\[21\]](#)

All of these disclosures must be made with specificity. While the exact fees or other contractual terms need not necessarily be disclosed, "mere disclosure," for example, "of the fact that other investors are paying lower fees" is not sufficient . . . an adviser must describe the lower fee terms, including the applicable rate (or range of rates if multiple investors pay such lower fees), in order to provide specific information as required by the rule."

**Steps Toward Implementation: Begin Now.** As with the Restricted Activities Rule, VC Fund Advisers and other ERAs should begin collaborating with counsel now to assess the extent to which the Preferential Treatment Rule will affect their operations, contracts (including fund offering documents), and policies and procedures. Tasks will include:

- Identifying and memorializing existing redemption and information rights that can be grandfathered under the legacy status provisions;

- Determining whether to take advantage of any of the offer-based exceptions that allow preferential treatment and if so, preparing standard offer and disclosure templates; and
- Reviewing protocols, contracts (including fund offering documents, and policies and procedures for any necessary updates.

It will be important for VC Fund Advisers and other ERAs to document their compliance with the offer exceptions for preferential redemption and information rights described above, by maintaining records of each such communication.

*The compliance deadline for the Preferential Treatment Rule for firms with > \$1.5 billion in private fund assets is 12 months from publication of the new rules in Federal Register, and 18 months for firms with < \$1.5 billion.*

## Conclusion

The SEC's new rules for private fund advisers, including VC Fund Advisers and other ERAs, are multifaceted and stand to disrupt the way some firms do business. Like the rule proposal that would have plumbed even farther into the depths of private fund firm operations, the new rules have not been well received. Indeed, their ultimate fate remains in the balance as well-known industry groups have sued the SEC over the new rules. That, and any similar litigation, is unlikely to resolve, however, before the compliance date for the new rules, which is approximately a year away for larger firms. As noted above, we suggest that firms go ahead and begin the journey to full compliance with the new rules now. Our team is available to assist.

## APPENDIX A: Quick Answers on the SEC's New Private Fund Adviser Rules

	<b>WHO does this apply to?</b>	<b>WHAT does it require?</b>	<b>WHEN is the deadline?</b>	<b>WHERE is there a way out?</b>	<b>WHY is the SEC doing this?</b>
<b>Quarterly Statement Rule</b>	RIAs	Quarterly investor statements detailing fund fees, expenses and performance	18 months from publication of final rules	None	Concerns with conflicts and fraud, misleading/insufficient disclosure

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<b>Mandatory Audit Rule</b>	RIAs	Obtain an independent audit and distribute audited financial statements consistent with the custody rule (nothing new for most firms)	18 months from publication of final rules	None	Concerns with conflicts and fraud, misappropriation of assets and valuation accuracy
<b>Adviser-Led Secondaries Rule</b>	RIAs	Distribute an independent fairness opinion or valuation opinion and disclose material business relationships with opinion provider	12 or 18 months from publication of final rules *	None	Concerns with conflicts and fraud, investor manipulation
<b>Restricted Activities Rule</b>	RIAs and ERAs	<p>Restriction on the following to a private fund without appropriate disclosure along specified timelines:</p> <ul style="list-style-type: none"> <li>• Charging adviser investigation expenses or adviser regulatory, examination or compliance fees</li> <li>• Post-tax clawbacks</li> <li>• Non-pro rata allocations</li> <li>• Borrowing from the fund</li> </ul>	12 or 18 months from publication of final rules*	<p>Disclosure and consent-based exemptions</p> <p>Legacy treatment for operating funds with agreements made prior to the compliance date #</p>	Concerns with conflicts and fraud, misleading/insufficient disclosure

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<b>Preferential Treatment Rule</b>	RIAs and ERAs	Prohibition on providing the following to a private fund investor without appropriate offers and disclosure along specified timelines: <ul style="list-style-type: none"> <li>• Preferential redemption and information rights, if a potential material, negative effect on other investors</li> <li>• Preferential treatment related to material economic terms</li> <li>• Annual transparency report</li> </ul>	12 or 18 months from publication of final rules*	Offer and disclosure-based exemptions  Legacy treatment for operating funds with agreements made prior to the compliance date	Concerns with conflicts and fraud, material negative effects on other investors and adviser incentives

**Endnotes**

[1] [Private Fund Advisers; Documentation of Registered Investment Adviser Compliance](#), SEC Release No. IA-6383 (Aug. 23, 2023) (Adopting Release).

[2] Under the Advisers Act, a "private fund" is any issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for Sections 3(c)(1) or 3(c)(7) thereof.

[3] An exempt reporting adviser is generally an investment adviser that qualifies for the exemption from registration under Section 203(l) of the Advisers Act (VC Fund Advisers) or Section 203(m) of the Advisers Act (other private fund advisers with less than \$150 million in assets under management).

[4] See generally Adopting Release at Section II.E.

[5] An adviser generally will satisfy the requirement to "distribute" disclosure when it sends the disclosure to all investors in a fund, including the underlying investors of any investor that is itself a fund or other pooled vehicle. Distribution can be achieved, and written consent can be obtained, electronically in keeping with existing SEC guidance.

[6] With investors that are funds of funds or other pooled vehicles and in a "control relationship" with the adviser or any of its related persons, the adviser must work to distribute disclosure to and obtain consent from the underlying individual investors. An entity is in a control relationship with an adviser or its related person if it is controlling, controlled by or under common control with the adviser or its related person. New Rule 211(h)(1)-1 under the Advisers Act defines control for these purposes as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. In addition, under the new rule: (1) an adviser's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) are presumed to control the adviser; (2) a person is presumed to control (a) a corporation, if the person has the right to vote 25% or more of a class of the voting securities or power to sell 25% or more of a class of the voting securities, (b) a partnership if the person has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the partnership, and (c) a limited liability company (LLC) if the person has the right to vote 25% or more of a class of the LLC interests or the right to receive upon dissolution, or has contributed, 25% or more of the capital of the LLC, or is an elected manager of the LLC; and (3) a person is presumed to control a trust if the person is a trustee or managing agent of the trust.[2]

[6] The disclosure must be distributed within 45 days after the end of the fiscal quarter in which the relevant activity occurs.

[8] Costs related to an investigation of the adviser that results in Advisers Act sanctions may not be allocated to a private fund even with disclosure and consent, including where the adviser consented to an SEC order without admitting or denying the SEC's findings.

[9] The disclosure must include the dollar amount of the fees and expenses charged to the private fund.

[10] A "clawback" is "any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements."

[11] The disclosure must include the dollar amount of the adviser clawback before and after reduction for actual, potential, or hypothetical taxes.

[12] The disclosure must explain why the non-pro rata allocation is fair and reasonable and must "allow an investor to understand better how the adviser is treating the private fund relative to other private funds or clients advised by the adviser." The disclosure should address any conflicts of interest (such as additional compensation payable to the adviser) and risks of potential harms or other disadvantages for investors created by the non-pro rata allocation. It should also address the factors considered by the adviser in making the non-pro rata allocation and its determination of fairness and reasonableness. The SEC explains that whether an allocation or charge is fair and equitable depends on the facts and circumstances, including "factors relevant to the specific expense," for example, whether the charges relate "to a specific type of security that [only] one private fund client holds" or "a bespoke structuring arrangement for one private fund client to participate [that] does not benefit other clients" or a situation in which one private fund will benefit from the expense relative to other funds, "such as the potential benefit of certain insurance policies."

[13] Note that the SEC does not interpret ordinary tax advances or management fee offsets as borrowings for the purposes of this restricted activity.

[14] A fund will be considered to have commenced operations where there is "any bona fide activity directed towards operating a private fund, including investment, fundraising, or operational activity," such as "issuing capital calls, setting up a subscription facility for the fund, holding an initial fund closing and conducting due



diligence on potential fund investments, or making an investment on behalf of the fund."

[\[15\]](#) See generally Adopting Release at Section II.G.

[\[16\]](#) This is defined as any pooled investment vehicle, other than an investment company registered under the Investment Company Act of 1940 or a securitized asset fund, that has substantially similar investment policies, objectives or strategies to those of the private fund, which requires a facts and circumstances analysis. The types of vehicles that would fall under qualifying "pool" is broad, and not restricted to just private funds and is structure and entity agnostic. These SEC notes that while a pool with a materially a different target return or industry focus from a private fund would likely not share substantially similar investment policies, objectives, or strategies, it could be possible, for example, for a healthcare-focused private fund to be considered a similar pool of assets to the adviser's other technology-focused private fund.

[\[17\]](#) This is intended to be an objective measure based on the facts and circumstances at the time the adviser grants or provides the preferential treatment and the adviser is not required to predict how others will react to it. "This standard is designed to facilitate the effective operation of the rule and to help ensure that preferential treatment granted to one investor does not have deleterious effects on other investors."

[\[18\]](#) The SEC has not provided a definition for the term "material, negative effect," so as to keep the rule "evergreen."

[\[19\]](#) The SEC provides as an example a "pension plan subject to State or local law . . . required to redeem its interest under certain circumstances, such as a violation by the adviser of State pay-to-play, anti-boycott, or similar laws." Any such preferential treatment must be disclosed pursuant to new Rule 211(h)(2)-3(b).

[\[20\]](#) In other words, there can be no exclusions, whether applied directly or indirectly, based on investor status, affiliation, or commitment size. As an example of a direct qualification, the SEC imagines "an adviser offering a fund with three share classes, each with different liquidity options but that are otherwise subject to the same terms" and restricting the more favorable classes to certain investor groups. Indirect qualifications are also prohibited and discussed in the Adopting Release.

[\[21\]](#) The SEC envisions this requirement driving "advisers to reassess periodically the preferential terms they provide to investors in the same fund, and investors will benefit from receiving periodic updates on preferential terms provided to other investors in the same fund (e.g., investors will benefit because they will be able to assess whether such preferential treatment presents new conflicts for the adviser)."

\* 12 months for firms with ? \$1.5 billion in private fund assets; 18 months for firms with < \$1.5 billion.

# Not available for fees or expenses related to an investigation that results in Advisers Act sanctions for the adviser.

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