

## The SEC's Private Fund Adviser Rules Explained Part 4: The Quarterly Statement Rule

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As we have discussed in earlier Client Alerts, on August 23, 2023, the U.S. Securities and Exchange Commission (SEC) adopted new and amended rules under the Investment Advisers Act of 1940, as amended (the Advisers Act), to address certain conflicts of interest and promote investor protection in the private funds industry (the Private Fund Adviser Rules). Our first **Client Alert** on this topic provided an overview of the Private Fund Adviser Rules. We also prepared a **Client Alert** addressing new Rule 211(h)(2)-1 (the Restricted Activities Rule), a **Client Alert** addressing new Rule 211(h)(2)-3 (the Preferential Treatment Rule), and a **Client Alert** regarding the SEC's statements in the Private Fund Adviser Rules' adopting release (Adopting Release) concerning investment advisers' fiduciary duties with respect to the private funds they manage. This Client Alert addresses another of the Private Fund Adviser Rules, Rule 211(h)(1)-2 (the Quarterly Statement Rule), which requires certain investment advisers to private funds to prepare and distribute to investors in the private funds they manage quarterly statements that detail, among other things, the fund's performance, fees, and expenses.

### Overview of the Quarterly Statement Rule

The Quarterly Statement Rule is largely consistent with the proposed version of the rule the SEC issued in February 2022, but includes a few modifications as described below. It applies only to investment advisers to private funds who are registered or required to be registered with the SEC (covered advisers) and does not apply to state-registered advisers or exempt reporting advisers. It also does not apply to (x) covered advisers with respect to securitized asset funds they advise or (y) the non-U.S. private fund clients of SEC-registered offshore advisers, regardless of whether the fund has U.S. investors. The rule does, however, apply to SEC-registered offshore advisers to the U.S.-domiciled private funds they advise. The Adopting Release also makes clear that the quarterly statements required by the rule represent a baseline level of reporting and covered advisers and their investors would not somehow be restricted from negotiating for additional bespoke reporting.

### Fee and Expense Disclosure

The quarterly statements required by the rule must disclose to investors specific information regarding the covered adviser's private fund's fees and expenses and any compensation paid or allocated to the covered adviser (or its related persons) by the fund, as well as any compensation paid or allocated to the covered adviser (or its related persons) by the fund's underlying

portfolio investments. The fee and expense disclosures can be categorized as either private fund-level or portfolio investment-level disclosures.

### *Private Fund-Level Disclosures*

The rule requires covered advisers to disclose the following information in a table in the statement:

1. All compensation, fees, and other amounts allocated or paid to the covered adviser (or its related persons) by the private fund (adviser compensation) during the reporting period
2. All fees and expenses allocated to or paid by the private fund during the reporting period, other than the adviser compensation described above (fund expenses)
3. The amount of any offsets or rebates carried forward during the reporting period to later periods to reduce future payments or allocations to the adviser or its related persons

With respect to adviser compensation and fund expenses, the table must contain separate line items for each category of allocation, payment, fee, or expense, reflecting the total dollar amount of adviser compensation and fund expenses. Adviser compensation would include (but not be limited to) management, advisory or sub-advisory fees, and performance-based compensation, while fund expenses would include (but not be limited to) organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses. The Adopting Release clarifies that covered advisers may not group smaller types of compensation or expenses into broad categories such as "miscellaneous" or exclude de minimis compensation or expenses. Moreover, to the extent a fund expense could also constitute adviser compensation, it should be disclosed as adviser compensation. Adviser compensation and fund expenses must also be presented both before and after the application of any offsets, rebates, or waivers. These private fund-level disclosure requirements were adopted in the final rule substantively as the SEC had proposed.

### *Portfolio Investment-Level Disclosures*

The rule also requires covered advisers to disclose in a table in the statement all portfolio investment compensation allocated or paid to the covered adviser or its related persons during the reporting period. The rule defines a portfolio investment to mean any entity or issuer in which the private fund has directly or indirectly invested.

The table must show separate line items for each category of allocation or payment, reflecting the total dollar amount of compensation. The Adopting Release states such categories would include, for example, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, and similar fees or payments by the portfolio investment to the covered adviser or its related persons. The covered adviser must disclose the amount of compensation attributable to the private fund's interest in the portfolio investment, which should not reflect portions attributable to any other person's interest. As in the private fund-level disclosures, the compensation amounts must be presented both before and after the application of any offsets, rebates, or waivers.

The Adopting Release clarifies that the portfolio investment-level disclosures are intended generally to capture potentially or actually conflicted compensation arrangements where the fund's interest in a portfolio investment may be negatively impacted by that portfolio investment's allocation or payment of compensation to the covered adviser or its related persons, such as when the adviser charges a monitoring fee. The SEC adopted these disclosure requirements largely as it had initially proposed. It did not, however, adopt a portion of the proposal that would have required covered advisers to disclose the private fund's ownership percentage of the portfolio investments.

#### *Calculations and Cross-References to Fund Documents*

The rule also requires the quarterly statements to include a prominent disclosure regarding the manner in which the expenses, payments, allocations, rebates, waivers, and offsets in the statement have been calculated. The Adopting Release clarifies that this generally requires the covered adviser to describe, among other things, the method used to determine any performance-based compensation, such as the distribution waterfall (if applicable), and the criteria on which each type of compensation is based. The quarterly statement must also include cross-references to the relevant sections of the fund's organizational and offering documents describing the calculation methodology.

#### Performance Disclosure

The quarterly statements must also include standardized fund performance information. The categories of information to be included depend on whether the fund is a liquid fund or an illiquid fund, but in all cases, the categories of information must be displayed with equal prominence.

#### *Liquid Funds*

Covered advisers to liquid funds must disclose in the quarterly statements the following types of information relevant to the quarterly period:

1. The fund's annual net total returns since its inception or for each fiscal year over the 10 fiscal

years before the statement is issued, whichever period is shorter

2. The fund's average annual net total returns over the past one-, five-, and 10-fiscal-year periods (to the extent such information exists)
3. The fund's cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the statement

The SEC adopted the disclosure requirements regarding liquid fund performance essentially as it had proposed. However, with respect to the first category of information, the proposed version of the rule sought to require disclosure of annual net total returns since inception in all instances.

#### *Illiquid Funds*

Covered advisers to illiquid funds must disclose in the quarterly statements the following performance figures both with and without the impact of fund-level subscription facilities:

1. The fund's gross internal rate of return and gross multiple of invested capital
2. The fund's net internal rate of return and net multiple of invested capital
3. The gross internal rate of return and gross multiple of invested capital for both the realized and unrealized portions of the fund's portfolio, with the realized and unrealized performance shown separately

The statement must show these performance figures since the fund's inception and through the end of the quarter covered by the statement. To the extent quarter-end numbers are not available at the time the statement is distributed, the statement must include performance measures through the most recent practicable date. The adviser must also provide a statement of contributions and distributions for the illiquid fund reflecting the aggregate cash inflows from investors and aggregate cash outflows from the fund to investors, along with the fund's net asset value.

#### Liquid v. Illiquid Funds

As stated above, the categories of private fund performance information to be disclosed in the quarterly statements depend on whether the fund is a liquid or an illiquid fund. The rule defines an illiquid fund as 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. A liquid fund is simply a private fund that is not an illiquid fund. The SEC had initially proposed a more complex definition of illiquid fund that would have considered the duration of the fund's life, whether it continuously raises capital, and its investment strategy, but the final rule simplifies the definition to consider only redemption and withdrawal capability, which the SEC states in the Adopting Release is the distinguishing feature between illiquid and liquid funds.

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<sup>5</sup> See pages 14-15, 63, and 75-76 of Adopting Release, where the SEC cites enforcement actions against private funds it has pursued for fraudulent practices related to fee and expense charges or allocations that are influenced by the advisers' conflicts of interest and failing to disclose material conflicts of interest.

<sup>6</sup> See pages 209 and 234 of the Adopting Release.

<sup>7</sup> See page 251 of the Adopting Release.

<sup>8</sup> See page 255 of the Adopting Release.

The Adopting Release contains helpful guidance for covered advisers seeking to determine whether their private fund is a liquid or an illiquid fund. The release states that, while illiquid funds generally do not offer voluntary redemptions or withdrawals, there may be exceptional circumstances for illiquid funds where redemption or withdrawal would be allowed, such as in response to regulatory events and other extraordinary circumstances such as violations of certain laws. By contrast, liquid funds generally allow voluntary investor redemptions on a periodic basis, such as monthly, quarterly, or semiannually.

#### Preparation and Disclosure of Quarterly Statements

The Quarterly Statement Rule requires the quarterly statements to be prepared and distributed to investors within certain prescribed time periods. For private funds that are not funds-of-funds, the statements must be distributed within 45 days after the first three fiscal quarter-ends of each fund fiscal year and within 90 days after the end of each fund fiscal year. For private funds that are funds-of-funds, the statements must be distributed within 75 days after the first three fiscal quarter-ends of each fund fiscal year and within 120 days after the end of each fund fiscal year. With respect to a newly formed private fund, a quarterly statement must be prepared and distributed following the fund's second full quarter of generating operating results.

#### *Meaning of Fund-of-Funds*

The term fund-of-funds is not defined in the new Private Fund Adviser Rules. However, some guidance may be gleaned from the Adopting Release as to when a fund may be considered a fund-of-funds for purposes of the Quarterly Statement Rule. The SEC's Division of Investment Management issued an [FAQ response](#), last modified in March 2010, which defines a fund-of-funds as "a pooled investment vehicle that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser."<sup>1</sup> Though the FAQ response contains a disclaimer that it is only an expression of the views of the staff of the Division of Investment Management and not a formal rule, regulation, or statement approved by the SEC, the Adopting Release actually cites to this FAQ response when discussing another of the Private Fund Adviser Rules.<sup>2</sup> This appears to suggest that the SEC considers this FAQ response (which includes a definition of fund-of-funds) as reliable guidance for interpreting the Private Fund Adviser Rules.

#### Consolidated Reporting for Certain Private Fund Structures

The Quarterly Statement Rule requires advisers to consolidate reporting for similar pools of assets to the extent doing so would provide more meaningful information to the private funds' investors and not be misleading. This requirement appears to address certain concerns presented by private funds that employ master-feeder structures. Because the feeder funds serve as conduits for their investors to access the master fund and its investments, the rule will generally require the covered adviser to provide feeder fund investors with a single, consolidated quarterly statement covering the applicable feeder fund and its proportionate interest in the master fund (so long as the consolidated statement provides

more meaningful information and is not misleading). The SEC also explains in the Adopting Release that covered advisers generally should consider any input they receive from investors regarding what approach to consolidation they view as most meaningful. This latter directive may prove problematic in practice, however, as the needs and opinions of a fund's investors will inevitably vary.

#### Format and Content Requirements

The Quarterly Statement Rule requires the covered adviser to use clear, concise, plain English in the quarterly statements. The Adopting Release also states that, to the extent the covered adviser includes information in a quarterly statement that is not specifically required by the rule, that additional information must be as concise as practicable and never more prominent than the information actually required by the rule. It must also not obscure the investor's understanding of the required information. Moreover, all information contained in the quarterly statements must be presented in a format that facilitates review from one quarterly statement to the next (i.e., a covered adviser generally should use consistent formats quarter over quarter to allow investors to easily compare fees, expenses, and performance). This requirement will put additional pressure on covered advisers to include correct content and develop a workable format from the outset, as changes in subsequent reports would undermine the rule's emphasis on consistency.

#### Related Recordkeeping Requirements

The SEC adopted companion amendments to Rule 204-2 under the Advisers Act, which requires covered advisers to retain books and records related to the Quarterly Statement Rule. First, covered advisers must make and retain a copy of any quarterly statement distributed to private fund investors pursuant to the rule, as well as a record of each addressee and the date the statement was sent. Second, advisers must make and retain records evidencing the calculation methods utilized for any expenses, payments, allocations, or other calculated item. Finally, advisers must make and keep books and records substantiating the adviser's determination that a private fund client is either a liquid fund or an illiquid fund.

#### No Legacy Status

Unlike certain aspects of the Restricted Activities Rule and the Preferential Treatment Rule discussed in earlier Client Alerts, the SEC did not grant legacy status for any aspect of the Quarterly Statement Rule. Therefore, the Quarterly Statement Rule will come into effect on the Effective Date (defined below).

#### **Our Thoughts**

The Quarterly Statement Rule imposes entirely new requirements on covered advisers from both a legal and an accounting perspective. Though advisers may already have systems in place to prepare certain financial statements (i.e., statements prepared in accordance with GAAP) and report performance (i.e., pursuant to the SEC's Marketing Rule), and those systems could certainly inform the reporting required by this new Quarterly Statement Rule, the reporting requirements under this new rule are truly unique, and covered advisers should take steps now to ensure they will be able to distribute fully compliant

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<sup>1</sup> This definition appears in the SEC's response to Question VI.7 of the FAQ.

<sup>2</sup> See footnote 537 of the [Adopting Release](#).

quarterly statements by the time the rule comes into effect. Advisers would be well advised to work with their administrators and professional advisors to create mock-up quarterly statements and determine automated solutions for extracting the information required to be reported. This may also help advisers identify any ambiguities in fund documents that need correction, particularly with respect to expenses and calculation methodologies, and inform what messaging advisers may want to make to investors prior to distributing their first statements. Such exercises could also help advisers determine how performance information in the quarterly statements compares to marketing materials (so that they can consider conforming marketing materials to reflect quarterly statement performance to avoid any inconsistencies).

The Quarterly Statement Rule will also require covered advisers to obtain a substantial amount of information regarding the private funds they advise and those funds' portfolio investments. Covered advisers should inventory each item of information they will be responsible for obtaining and adjust their policies and procedures to ensure such information will be collected in a timely and consistent manner. Covered advisers may want to engage professional service providers to track and consistently calculate the allocations, payments, fees, and expenses, as well as the performance information, required to be disclosed by the rule.

Advisers should particularly take note of the extensive efforts that may be required to obtain the requisite information at the portfolio investment level. As stated above, the rule requires covered advisers to include in their quarterly statements certain information about the compensation paid or allocated to the covered advisers and their related persons by their private funds' portfolio investments. The SEC clarifies that a fund's portfolio investments include any entities or issuers in which the fund has invested, *even if indirectly by investing in another fund (e.g., via a fund-of-funds) that invests in that entity or issuer*. The SEC recognizes the potential hardships imposed by this requirement, especially for advisers to funds-of-funds who rely on the advisers to the funds in which they invest to provide the required information. But the SEC indicates in the Adopting Release that advisers could seek to mitigate this hardship by, for example, asking the funds in which they invest to provide a list of their investments (so that the covered adviser may examine such issuers/entities to see if they pay any compensation) or include a requirement to provide such information about the issuers/entities in the contractual agreements between the covered advisers and the funds in which they invest. The SEC also recognizes that, despite its best efforts, a covered adviser may not be able to obtain the required information for every underlying portfolio investment. In that case, however, the adviser would be well advised to make a good faith determination and document both this determination and its diligence efforts.

Another issue to consider with respect to funds-of-funds is the Quarterly Statement Rule's requirement that the covered adviser distribute the quarterly statements to the private fund's investors. The SEC indicates in both the rule's definition of "distribute" and the Adopting Release that if the private fund investor is a pooled investment vehicle that is in a control relationship with the covered adviser (or its related persons), the covered adviser must "look through" the control pool and send the quarterly statements to the *actual investors* in the pool. Essentially,

the SEC realizes that other funds such as funds-of-funds (investing funds) may invest in a private fund advised by the covered adviser and, if that investing fund is in a control relationship with the covered adviser (or one of its related persons), a loophole would exist whereby the covered adviser could technically satisfy the rule's distribution requirement by delivering the statement to itself (or its related person). This would of course defeat the purpose of the Quarterly Statement Rule. To close this loophole, the rule requires the covered adviser in this scenario to distribute the statement to the *actual investors* in the investing fund (instead of to the investing fund's adviser with whom the covered adviser is in a control relationship). The SEC noted, however, that this concern does not exist when the investing fund is an *unaffiliated* fund-of-funds (i.e., there is no control relationship). In that case, the covered adviser can satisfy the distribution requirement by sending the quarterly statement to the investing fund's *adviser* and would not need to "look through" the private fund and send the statement to the fund's actual investors.

In sum, the quarterly statements required by the new rule will provide investors with much more detailed information on accounting and the application of fund documents than they have previously received. This may affect the fund investment dynamic, as prospective investors in new funds will likely ask for a fund's prior quarterly statements in future due diligence. To prepare for the new rule and the changes it will bring, covered advisers should take action now to ensure they are able to obtain the required information about the funds they manage and ensure such information will be presented consistently.

### Next Steps

All covered advisers must comply with the requirements imposed by the Quarterly Statement Rule by March 14, 2025 (the Effective Date). We encourage covered advisers to review their compliance policies and procedures and make updates where appropriate to ensure their compliance with the applicable provisions and disclosure requirements imposed by this rule before the Effective Date.

Please contact one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding this rule or the other Private Fund Adviser Rules.

# Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

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