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Navigating the SEC’s New Private Fund Rules

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On August 23, 2023, the US Securities and Exchange Commission (the "**SEC**" or "**Commission**") adopted sweeping final rules and rule amendments (together, the "**Final Rules**") that impose additional obligations and restrictions on advisers to "private funds."[1] As provided under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), for purposes of the Final Rules, a "private fund" is an issuer that would be an "investment company" *but for* the exception provided in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**").

The Final Rules adopted under the Advisers Act consist of the following:

- Quarterly Statement Rule: Rule 211(h)(1)-2
- Audit Rule: Rule 206(4)-10
- Restricted Activities Rule: Rule 211(h)(2)-1
- Adviser-Led Secondaries Rule: Rule 211(h)(2)-2
- Preferential Treatment Rule: Rule 211(h)(2)-3
- Compliance Rule: Rule 206(4)-7(b)

The Final Rules apply to varying degrees to private fund advisers that are registered with the SEC ("**RIAs**") and those that are exempt from registration, including exempt reporting advisers ("**ERAs**"). As further detailed below, the Restricted Activities Rule and Preferential Treatment Rule apply to all private fund advisers, while the Quarterly Statement Rule, the Audit Rule, and the Adviser-Led Secondaries Rule apply only to RIAs. The Final Rules also include a new requirement for written documentation of annual review of compliance programs in the Compliance Rule, which applies to all RIAs. See our chart in Section I below for more information.

While this white paper focuses on the Final Rules, as adopted, we note that the Final Rules include several significant changes from the original proposal,[2] largely reflecting the extensive comments the SEC received across the entire gamut of participants in the private fund markets. Many of these changes reflect a shift away from some of the more prescriptive (and most controversial) aspects of the proposal and—excepting some important aspects discussed in Section II below—a return to the traditional regime of disclosure and consent under the Advisers Act. In addition, in response to significant industry comments, the Final Rules provide key carveouts for securitized asset funds (i.e., private investment funds that issue asset-backed securities and whose investors are primarily debt holders, such as collateralized loan obligations ("**CLOs**")).

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[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Release No. 6383 (Aug. 23, 2023) [88 FR 63206 (Sept. 14, 2023)] (the "Adopting Release"), available at https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.

[2] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Release No. 5955 (Feb. 9, 2022) [87 FR 16886 (Mar. 24, 2022)], available at https://www.sec.gov/rules/proposed/2022/ia-5955.pdf; *See also* Mayer Brown's Legal Update on the proposal.

Private fund advisers based outside the United States will also note that, in the Adopting Release, the SEC reaffirmed its existing position under the *Unibanco* line of SEC staff no-action letters[3] and subsequent Commission guidance, providing that the Final Rules (other than the changes to the Compliance Rule) will be considered "substantive rules," and accordingly will not apply to non-US advisers, regardless of their registration status, with respect to their non-US private funds (even if such non-US funds have US person investors).

Practice Note: For non-US advisers subject to SEC registration or ERA notice filings, the SEC guidance does not alter long-standing practices under *Unibanco* regarding such advisers' relationships with non-US clients, including private funds.

However, global financial services firms should carefully assess whether their fund management structures would bring a non-US advisory affiliate within the scope of the Final Rules, such as circumstances where a US advisory affiliate (who is subject to the Final Rules) acts as sub-adviser to a non-US fund sponsored by the non-US advisory affiliate.

[3] *See, e.g.,* ABA Subcommittee on Private Investment Entities, SEC Staff No-Action Letter (Dec. 8, 2005); Royal Bank of Canada, SEC Staff No-Action Letter (June 3, 1998); ABN AMRO Bank, N.V., SEC Staff No-Action Letter (Jul. 7, 1997); Murray Johnstone Holdings Limited, SEC Staff No-Action Letter (Oct. 7, 1994); Kleinwort Benson Investment Management Limited, SEC Staff No-Action Letter (Dec. 15, 1993); Mercury Asset Management plc, SEC Staff No-Action Letter (Apr. 16, 1993); and Uniao de Bancos de Brasileiros S.A., SEC Staff No-Action Letter (Jul. 28, 1992).

I. Transition Period for Compliance

Rule & Internal Reference	Who is Covered	Larger Private Fund Advisers Compliance Dates	Smaller Private Fund Advisers Compliance Dates	Legacy Treatment[4]; Other Notes
Rule 211(h)(1)-2 Quarterly Statement Rule Section IV.B	**RIAs**	**18 months** March 14, 2025	**18 months** March 14, 2025	None.
Rule 206(4)-10 Audit Rule Section IV.C	**RIAs**	**18 months** March 14, 2025	**18 months** March 14, 2025	None.
Rule 211(h)(2)-1 Restricted Activities Rule Section III.A-D	**All Advisers**	**12 months** September 14, 2024	**18 months** March 14, 2025	Legacy treatment **only** for (a) aspects that require investor **consent**, e.g., adviser borrowing from a fund (specifically calls out that if borrowing document is already entered into then need not seek investor consent), and (b) charging for certain investigation fees and expenses. No need to amend organizational or borrowing documents entered into prior to compliance.
Rule 211(h)(2)-2 Adviser-Led Secondaries Rule Section IV.A	**RIAs**	**12 months** September 14, 2024	**18 months** March 14, 2025	None.
Rule 211(h)(2)-3 Preferential Treatment Rule Section III.E	**All Advisers**	**12 months** September 14, 2024	**18 months** March 14, 2025	Legacy treatment **only** for (a) preferential redemption rights and (b) information rights about portfolio holdings. No need to amend organizational documents or contractual arrangements entered into prior to compliance.
Rule 206(4)-7(b) Amended Compliance Rule Section IV.D	**All Advisers (even without private funds)**	**60 days** November 13, 2023	**60 days** November 13, 2023	All advisers must document, in writing, their next review commenced on or after November 13, 2023.

[4] Legacy status only applies to private funds that commenced operations as of the compliance date.

As set out in the table above, the SEC has provided for staggered periods by which advisers must comply with the Final Rules. The compliance periods vary depending on the rule as well as on the adviser's assets under management with private funds clients. For compliance purposes, the SEC has split investment advisers into two categories: (1) "*Larger Private Fund Advisers*" with $1.5 billion dollars or more in private funds assets under management and (2) "*Smaller Private Fund Advisers*" with less than $1.5 billion dollars in private funds assets under management. The "*private funds assets under management*" is to be calculated as of the last business day of the adviser's most recently completed fiscal year, in accordance with Part 1A, Instruction 5.b of Form ADV, for assets under management that are attributable to **only** "private funds."

Regardless of their size, all RIAs must comply with the Quarterly Statement Rule (see Section IV.B below), and the Audit Rule (see Section IV.C below) by March 14, 2025. The SEC chose a longer compliance period because these two rules involve third-party vendors and the "surprise examination" option that is sufficient for audit compliance under Rule 206(4)-2 of the Advisers Act (the "**Custody Rule**") will not be sufficient under the new audit rule.

The SEC adopted staggered compliance periods for the Restricted Activities Rule (see Section III.A-D below), the Adviser-Led Secondary Rule (see Section IV.A below), and the Preferential Treatment Rule (see Section III.E below). Larger Private Fund Advisers must comply with these new rules by September 14, 2024, while Smaller Private Fund Advisers must comply by March 14, 2025. Finally, all RIAs, regardless of size and whether or not they advise private funds, must document, in writing, their next compliance review that is *commenced* on or after November 13, 2023.

The SEC has granted selective legacy status or "grandfathering" to certain aspects of the Final Rules that will apply to private funds that have already commenced operations as of the applicable compliance date. Specifically, legacy status is applied to the aspects of the Restricted Activities Rule *that require investor consent* (i.e., the adviser borrowing from a fund and charging the fund for certain investigation expenses). In particular, legacy treatment will be given to funds under the Restricted Activities Rule ***only if*** the rule would require the governing documents (or side letters) of the fund to be amended in order to comply with the Restricted Activities Rule. Legacy status is granted with respect to the Preferential Treatment Rule for preferential redemption rights and information rights already in place for investors in funds that have already commenced operations as of the date of compliance; it is important to note, however, that the disclosure portions of the rule do not benefit from legacy status. When considering amending current governing documents of funds to address the Final Rules, the legacy status granted to the above activities does not require an adviser to amend any current fund agreements and organizational documents. Further, an adviser may not amend an existing side letter as a work-around to gain legacy treatment of one of these rights for an existing investor. Lastly, when considering legacy treatment, the SEC noted that it will only apply to those funds that have had "bona fide" activity to commence operations as of the compliance date, such as issuing capital calls, entering into a subscription facility, holding an initial closing, or performing diligence on potential fund investments.

II. Impact of New SEC Guidance on Items That Were Proposed but Not Adopted

As noted above, in adopting the Final Rules, the SEC generally shifted aspects of the various rules from a prescriptive approach prohibiting certain conduct or activities to a disclosure-based approach consistent with the historical approach to regulation under the Advisers Act. As part of this change, although the SEC ultimately declined to prohibit certain activities under the Restricted Activities Rule, the SEC provided important guidance through the Adopting Release that has the effect of calling into question—or implicitly banning—the practices they declined to outright prohibit by rule.

First, the SEC declined to adopt any provision explicitly prohibiting an adviser from charging fees to a fund's portfolio investment for monitoring, servicing, consulting, or other fees in respect of services that the adviser does not, or does not reasonably expect to, provide to the portfolio investment. This proposed restriction was clearly intended to address the SEC's concerns regarding "accelerated monitoring fees," and similar practices. Although the SEC did not adopt this restriction, it unambiguously views these practices as inconsistent with an adviser's fiduciary duty, explaining that "charging fees without providing or reasonably expecting to provide a corresponding service to its private fund client, in our view, would cause the adviser to place its own interests ahead of its client's interests."[5] Notably, while most of the SEC's prior enforcement activities related to accelerated monitoring fees have focused on lack of meaningful disclosure of these fee practices and attendant conflicts of interest, here the SEC further analogizes these practices to a failure to return pre-paid advisory fees for services not actually performed to support its view that the practice, even if disclosed, cannot be reconciled with the adviser's obligations to its clients.

> Practice Note: Because this aspect of the Adopting Release is not actually part of the Final Rules, the guidance provided should be treated as official SEC guidance with immediate effect, without any conformance period. Fund advisers that currently have accelerated monitoring fee arrangements with portfolio companies and similar provisions—even if fully and prominently disclosed to fund investors—should strongly consider waiving receipt of such fees.

Second, the SEC declined to adopt the proposed prohibition on an adviser seeking reimbursement, indemnification, exculpation, or limitation of liability by its private fund client or the fund's investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the fund. Many market participants viewed this aspect of the proposal as controversial because of the shift from a "gross negligence" liability standard common in many fund governing documents to a "simple negligence" liability standard. While, as above, the SEC ultimately declined to adopt this restriction into the Final Rules, through guidance in the Adopting Release, it has sought to largely reach a similar

[5] Adopting Release at page 251.

result, noting that actually adopting the prohibition was not necessary to address what it viewed as a "problematic practice."

The SEC, in "reaffirming and clarifying" its views on how an adviser's fiduciary duty applies to private fund clients, and how the Advisers Act antifraud provisions apply to the adviser's dealings with clients and fund investors, actually provided important new guidance that will shape how all advisers draft contractual provisions related to indemnification and exculpation, and how they exercise those contractual provisions. We distill the SEC's guidance as follows:

- The SEC reminded advisers of their obligation to act consistently with their federal fiduciary duty (which arises out of Section 206 of the Advisers Act) and their legal obligations under the Advisers Act, including the antifraud provisions.
- The SEC reminded advisers that a waiver of the adviser's compliance with its federal antifraud liability for breach of its fiduciary duty to a private fund or other client, or of any other provision of the Advisers Act, or rules thereunder, is invalid under Section 215(a) of the Advisers Act.
- As examples (and not by way of limitation), the SEC described two types of contractual provisions (based in part on staff observations) that would violate the antifraud provisions of the Advisers Act: (i) a provision that waives any and all of the adviser's fiduciary duties, and (ii) a provision that explicitly or generically waives the adviser's federal fiduciary duty, where in each case there is no language clarifying that the adviser's federal fiduciary duty is not waived or that the client retains certain non-waivable rights (i.e., a "savings clause").
- The SEC supported these views by reminding advisers that a breach of the federal fiduciary duty may involve conduct that is intentional, reckless, or negligent (thus indicating that applying a blanket gross negligence standard to acts or omissions that would constitute a violation of the federal fiduciary duty is itself violative of the Advisers Act).
- Importantly, the SEC set out its belief that an adviser may not seek reimbursement, indemnification, or exculpation for breaching its federal fiduciary duty because such reimbursement, indemnification, or exculpation would operate effectively as a waiver, which would be invalid under the Advisers Act.

Practice Notes: Because this aspect of the Adopting Release is not actually part of the Final Rules, it is effective immediately, and there is no conformance period. Moreover, this guidance is not limited solely to private funds, and applies equally to all types of institutional advisory arrangements, including to CLOs and other securitized asset funds that are generally excluded from the Final Rules (as well as other types of commingled funds that are not "private funds" at all).

All advisers to funds and other institutional clients[6] should review their existing fund governing documents and advisory agreements to assess any indemnification and exculpation provisions and strongly consider adding (through a unilateral amendment process, if permitted) a "savings clause" to explicitly confirm that the non-waivable federal fiduciary duty has not been waived.

Moreover, advisers should consider implementing processes and controls to assess and confirm, prior to actually invoking such indemnification and exculpation provisions, whether the relevant loss or expense arose out of any breach of the adviser's federal fiduciary duty (including a breach premised on simple negligence) in light of the SEC's new guidance.

III. Restrictions Applicable to All Private Fund Advisers

A. Generally

The Final Rules restrict certain activities that the SEC believes involve conflicts of interest and compensation schemes that are contrary to the public interest. Generally, such activities may be engaged in with disclosure to and, in some instances, consent from, investors. For any investors that are pooled investment vehicles in a control relationship with the adviser (e.g., master-feeder structures and affiliated fund-of-funds), such disclosures and consent requests will need to be distributed on a "look-through" basis.

Each consent-based exception will require an adviser to obtain consent for the restricted activity from at least a majority in interest of investors that are not related persons[7] of the adviser. A fund's governing documents may impose a higher threshold and, consistent with market practice, exclude defaulting investors for voting purposes. The consent requirement will not apply to funds the investors of which are

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[6] Note that any hedge clauses used with retail clients should be extremely narrow, if used at all.

[7] The Final Rules use the same definition of "related person" as used in Form ADV and Form PF and includes: (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser. The term "control" is the same definition used in Form ADV and is defined to mean the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. The definition, in addition, provides that: (i) each of an adviser's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the adviser; (ii) a person is presumed to control a corporation if the person: (A) directly or indirectly has the right to vote 25% or more of a class of the corporation's voting securities; or (B) has the power to sell or direct the sale of 25% or more of a class of the corporation's voting securities; (iii) a person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the capital of the partnership; (iv) a person is presumed to control a limited liability company if the person: (A) directly or indirectly has the right to vote 25% or more of a class of the interests of the limited liability company; (B) has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the limited liability company; or (C) is an elected manager of the limited liability company; or (v) a person is presumed to control a trust if the person is a trustee or managing agent of the trust. *See* Adopting Release at page 97.

solely related persons of the fund's adviser (e.g., employee-only funds).[8] Consent for a restricted activity must be obtained directly from investors rather than any other fund governance body (e.g., a limited partner advisory committee ("**LPAC**") or a board of directors), which the SEC believes may not have sufficient independence, authority, or accountability to oversee and consent to such conflicts of interest.[9] While the Adopting Release does not directly address the question of whether consent can be obtained by means of a "negative consent" process, it notes that "[a] fund's governing documents … may generally prescribe the manner and process by which the applicable threshold of investor consent is obtained,"[10] which suggests that a negative consent process could be used if appropriately authorized in the governing documents.

RIAs will be required to retain dated copies of any notification, consent, or other document distributed to or received from investors pursuant to this rule. ERAs may also wish to consider keeping such records, although not required under the rule, so that they are able to demonstrate compliance upon SEC request.

B. Fees and Expenses

i. Investigation Expenses

Under the Restricted Activities Rule, an adviser may charge or allocate to a private fund fees and expenses related to an investigation of the adviser or its related persons by a governmental or regulatory authority only if the adviser (1) gives prior written notice to all investors and (2) obtains prior written consent from at least a majority in interest of investors that are not related persons of the adviser. However, even where such notice is provided and consent is obtained, an adviser cannot charge a private fund any fees or expenses related to an investigation that results in a court or governmental authority imposing a sanction for a violation of the Advisers Act. This prohibition seems to stem specifically from SEC concerns regarding a rather narrow set of circumstances in which advisers have allegedly attempted to improperly cause clients to bear the cost of SEC fines and settlements.[11] Unlike the expenses described in Section III.B(ii) below, market practice is clear on such expenses, which are, in our experience, uniformly considered adviser "overhead." We do not believe this item will cause a change in market practice.

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[8] However, the Adopting Release did not explicitly address situations where an individual who was an employee of the adviser later departs the company but has not withdrawn from the fund. Potentially, this would cause the consent requirement to apply, and these now-former employees would effectively hold a veto right, as the sole investors able to vote.

[9] Notwithstanding these statements in the Adopting Release, the SEC has apparently not questioned the use of these governance mechanisms for approval of other consents under the Advisers Act, including with respect to principal transactions or "assignments" of advisory agreements.

[10] Adopting Release at footnote 623 and accompanying text.

[11] *See, e.g.,* SEC Litigation Release No. 23188 (Feb. 5, 2015), https://www.sec.gov/litigation/litreleases/2015/lr23188.htm.

ii. Regulatory, Compliance, and Examination Expenses

Under the Restricted Activities Rule, an adviser may charge or allocate to a private fund client for (1) any regulatory and compliance fees or expenses or (2) fees or expenses associated with an examination of the adviser or its related persons, only if the adviser provides itemized written notice to investors of such fees or expenses within 45 days after the end of the fiscal quarter in which such activity occurs. The Adopting Release characterized such fees and expenses as "customary costs of doing business" that are considered overhead payable by the adviser out of its own resources (typically, management fee streams). The SEC concluded that charging investors separately for such overhead, on top of management fees, is therefore a compensation scheme contrary to the public interest and protection of investors.

While the Adopting Release provides examples of such fees and expenses that we generally agree are considered adviser "overhead" by many industry participants (e.g., costs of a compliance consultant, costs of filing Form PF and Form ADV, and costs of an examination of the adviser or its related persons by the Division of Examinations), the text of the Restricted Activities Rule captures a much broader universe of what are traditionally considered fund expenses. The definition of "related persons"[12] includes persons directly or indirectly controlling, controlled by, or under common control with the adviser and would thus pick up the private fund itself (typically a limited partnership controlled by its general partner, which in turn is controlled by the adviser) as well as certain portfolio companies in which the fund holds more than a 25% voting interest. Accordingly, any regulatory or compliance costs of the private fund (rather than the adviser) as well as, potentially, those related to the acquisition of its portfolio companies (e.g., filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976) would potentially be captured by this detailed quarterly disclosure requirement.

It is possible that this broad reading was not intended by the SEC, and we are hopeful that it will be corrected in further guidance. However, in the Adopting Release, the SEC declined to clarify which compliance fees and expenses are related to the *adviser's* activities rather than the *fund's* activities[13] so, despite the stated goal of protecting investors from paying for *adviser* overhead, it is possible that the Final Rules may have been intentionally drafted to also capture the *fund's* compliance and regulatory expenses (or at least to leave the question murky enough that the only reasonable solution for an adviser is to provide additional disclosure).

While this rule likely was not drafted with tax audits in mind, its language appears to be sufficiently broad to encompass tax audits and other tax-related proceedings. However, it is unclear whether expenses of the adviser or its related persons relating to tax audits or other tax proceedings will be classified as examination expenses or investigation expenses for purposes of this rule. If these expenses are considered

[12] *See* footnote 7 above.

[13] "Some commenters suggested that we should explicitly clarify which compliance fees and expenses are related to the adviser's activities or the fund's activities. As we are not flatly prohibiting advisers from passing on compliance, regulatory, and examination expenses, we do not believe it is necessary to describe which fees and expenses are related to the adviser's activities or the fund's activities." Adopting Release at page 214.

examination expenses, advisers may seek reimbursement from the fund so long as they comply with the necessary disclosure requirements, which could indirectly inform investors of the existence of such tax audits. Conversely, if they are categorized as investigation expenses, advisers cannot be reimbursed for such expenses without obtaining consent from a majority of investors. Further clarification on this issue will be helpful.

Practice Notes: RIAs, who are subject to the Quarterly Statement Rule, will *generally* be able to comply with the disclosure requirements by including appropriate disclosure of these compliance, regulatory, and examination expenses in the quarterly reports for the first, second, and third fiscal quarters (which are also due within 45 days of quarter end, for most funds). However, RIAs to funds-of-funds (which have a longer reporting deadline for the quarterly report, but no similar extension of time under this rule) will need to provide special disclosure to meet the rule's timing requirements. All RIAs will also need to make special disclosures for the fourth fiscal quarter. ERAs and other unregistered private fund advisers will also need to make special disclosures.

The Adopting Release makes clear that proper disclosure of these compliance, regulatory, and examination expenses must be sufficiently detailed—e.g., expenses associated with preparing and filing an adviser's Form ADV cannot simply be disclosed to fund investors as "legal expenses." Given this guidance, and the murkiness regarding certain potential *fund* compliance and regulatory expenses noted above, we expect advisers will be well served by a high level of granularity in these disclosures.

iii. Allocation of Expenses on a Non-Pro Rata Basis

Under the Restricted Activities Rule, an adviser may charge private fund clients certain fees or expenses related to the same portfolio investment (or potential portfolio investment) on a non-pro rata basis provided (1) the non-pro rata allocation is "fair and equitable" under the circumstance, and (2) the adviser provides prior written notice to investors of the non-pro rata allocation along with an explanation of how such allocation is fair and equitable under the circumstances. The SEC believes charging such fees or expenses on a non-pro rata basis presents a conflict of interest because advisers may be motivated to allocate such fees in a way that results in maximum revenue to the adviser or for other business reasons, in each case, at the expense of a client.

As a general matter, advisers currently provide general disclosure of such non-pro rata fees, typically in connection with a co-invest vehicle, in the related private placement memorandum or fund governing document. This disclosure will now need to be coupled with notice of the specific facts and circumstances of each non-pro rata allocation *prior* to the adviser completing such charge or allocation. Given the commercial speed of co-investment opportunities, the advance notice requirement may be difficult to meet or, as some industry groups have asserted in a lawsuit challenging the Final Rules, "unworkable in practice."[14] Note that the client receiving the *benefit* of a smaller expense allocation than would be applicable on a pro rata basis is also entitled to receive such notice and explanation.

The Adopting Release does not provide much detail on what would make an allocation "fair and equitable under the circumstances" but did provide a few examples: an expense relates to a specific type of security that only one client holds, an expense relates to a bespoke structuring arrangement for a particular client, or one client receives a greater benefit from the expense relative to the other clients. We expect industry participants will take the position that a "flagship" or "main" fund derives a greater benefit from bearing certain fees and expenses that co-invest vehicles frequently do not incur as such an arrangement allows the "main" fund to participate in opportunities it would otherwise be unable to partake in at the entire amount offered (due to, for example, diversification constraints or general lack of capital) and provides the "main" fund with a stronger voting position without a commensurate expenditure.

In two sequential footnotes, the Adopting Release contemplates that an adviser to a fund that does not have resources to bear its pro rata share of expenses due to insufficient reserves or the inability to call capital may alleviate such issue by diluting such fund's interest in the portfolio investment in a manner that is "fair and equitable" if permitted by applicable laws, rules, regulations, and the applicable governing documents.[15]

Sponsors frequently encounter situations where it becomes necessary or appropriate to allocate withholding or other tax liabilities among different funds on a non-pro rata basis (because such funds may have different tax structures and different tax attributes of their investors). These allocations typically need to be made in a reasonable manner, making it relatively straightforward to show that such non-pro rata allocations are "fair and equitable." However, the requirement to provide advance notice could pose practical challenges to sponsors.

Certain withholding taxes could potentially be considered investor expenses, in which case they would fall outside the scope of this rule. Certain other withholding taxes, particularly those withheld at the source of a payment to the fund (e.g., from an underlying portfolio investment), or other tax liabilities imposed on an aggregator entity, for instance, could be categorized as fees or expenses related to a portfolio investment, which are subject to this rule. For those taxes that are subject to this rule, sponsors may find it necessary to provide advance notice when allocating the cost of such taxes to investors on a non-pro rata basis.

[14] Press-Kit-for-Private-Fund-Advisers-Rules.pdf (investmentcouncil.org)

[15] Adopting Release at footnotes 670 and 671.

Practice Note: Typically, sponsors inform investors about non-pro rata allocations of tax items through distribution notices, which are often distributed after the allocations have been made. To comply with this rule, however, sponsors may need to implement new processes to provide advance notice, in addition to the regular distribution notice.

The SEC's decision not to provide a specific definition of "pro rata" leaves room for the possibility that an allocation method that is based on factors other than the investors' relative ownership percentages could be considered a pro-rata allocation for purposes of this rule. For example, in a fund where investors are subject to different tax liabilities due to the application of varying treaty benefits, one could argue that a "pro rata" allocation might be determined by taking into account the tax benefits that apply to each investor under an applicable treaty, rather than solely relying on strict ownership percentages. Similarly, in a case where a fund generates tax credits from certain investments, such as renewable energy, a pro rata allocation could be based on the investors' capacity to utilize such credits. Further clarification on this issue will be helpful, especially if such clarification would provide sponsors greater flexibility to allocate tax liabilities in a reasonable and practical manner.

Practice Note: The disclosure requirements for non-pro rata allocation of expenses applies to any allocation among a private fund and an adviser's other clients. As a result, although securitized asset funds are generally not within the scope of the Final Rules, the limitation on non-pro rata allocation of expenses would encompass securitized asset funds to the extent that they are clients of an adviser and invest alongside another private fund client within the ambit of the Restricted Activities Rule.

C. Clawback Obligations

The Restricted Activities Rule allows an adviser to reduce the amount of any "adviser clawback" by actual, potential, or hypothetical taxes applicable to the adviser or its related persons, as long as a written notice reflecting the pre-tax and post-tax clawback amounts is distributed to the investors. An adviser clawback generally applies to any obligation of the adviser or its related persons (such as the fund's general partner), or their respective owners or interest holders, to restore or return performance-based compensation to the private fund, pursuant to the fund's governing agreements. This written notice must be distributed within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.

In general, this requirement aligns with the prevailing industry practice, as many fund agreements already include a similar disclosure requirement, although not necessarily on a 45-day timeframe. It is worth noting that while the disclosure requirement under the rule mandates a written notice of pre-tax and post-tax clawback amounts, it does *not* seem to require a detailed calculation of such figures.

Practice Note: Fund sponsors may need to implement a new process to ensure the timely distribution of the written notice within the 45-day timeframe. As with the regulatory, compliance, and examination expenses discussed in Section III.B(ii) above, for RIAs, such disclosure could be included in the fund's quarterly statement for the applicable fiscal quarter (for the first, second, or third fiscal quarter), which generally will be required to be delivered on the same timeframe (unless the clawback occurs in the fourth fiscal quarter, in which case there is a longer period in which to deliver the quarterly report and separate notice will need to be delivered); advisers to funds-of-funds, ERAs, and other unregistered advisers will need to also make separate provision for this disclosure. However, if the fund agreement requires the adviser to calculate the clawback amount based on its actual tax liabilities, rather than applying hypothetical tax liabilities, meeting this timeline could be practically challenging because the adviser may need to obtain tax information from each of the individual carry recipients. Accordingly, this new requirement may make it less likely that advisers will agree to reduce clawbacks by actual tax liabilities due to the additional administrative and compliance burden.

D. Borrowings

The Restricted Activities Rule prohibits an adviser from borrowing cash, securities, or other assets from a private fund client (a "**Borrowing**") without first disclosing the material terms of such Borrowing and obtaining the consent of the fund's investors. In effect, a private fund client may not be a lender to an adviser, whether by providing a loan or extending credit, directly or indirectly.

As in the case of other restricted activities requiring consent, the consent must be obtained from a majority in interest of unaffiliated investors, rather than an independent body such as an independent fiduciary, a board of directors, or an LPAC. Although disclosures to investors do not need to detail all specific terms, the disclosure should address all material terms, such as the amount of the Borrowing, the rate charged, the repayment schedule and other material terms related to the Borrowing. This provision of the Restricted Activities Rule was adopted in light of concerns raised by the SEC that Borrowings create the potential for conflicts between the private fund and the adviser, especially where the adviser is incentivized to use fund assets for the adviser's own benefit. As a result, advisers should also consider whether to update disclosures with respect to a Borrowing following the transaction to describe any material changes.

The SEC has expressly confirmed that tax distributions and management fee offsets (that may be viewed as advances against future carried interest distributions or management fees) are generally not Borrowings. However, certain fund agreements require or permit any portion of the amount distributable to the general partner that exceeds the general partner's tax basis in the fund to be treated as a loan to the general partner. This type of provision is designed to prevent the general partner from recognizing capital gains as a result of receiving a distribution for which the general partner does not yet have sufficient tax basis.

Practice Note: Advisers to funds that include these kinds of deemed Borrowings may wish to consider revising their fund agreements to help ensure that any deemed loan provision complies with this consent requirement (or may consider streamlining the process to provide a consent for this specific type of deemed loan, such as through a shortened "negative consent" process). If the fund agreement currently provides that such deemed loan treatment is mandatory, advisers should consider revising the fund agreement so that loan treatment is optional or contingent on obtaining consent from a majority in interest of investors. In addition, to address the practical need to create a deemed loan as and when necessary, the fund may consider, with a majority consent, placing a loan instrument that permits multiple draws as needed.

Although not addressed in the Adopting Release, it is likely that a guarantee provided by a private fund to an adviser would be viewed as a Borrowing.

Borrowings that were entered into prior to the compliance date are not subject to the requirements of the Restricted Activities Rule if the parties would be required to amend the fund's governing document as a result of the new requirements.

E. Preferential Treatment

i. Generally

Under the Preferential Treatment Rule, an adviser may not grant a fund investor or an investor in a "similar pool of assets" preferential liquidity or information rights if such rights would have a material negative effect on the private fund or similar pools of assets. A "similar pool of assets" is defined as a pooled investment vehicle (other than an investment company registered under the Investment Company Act, a company that elects to be regulated as such,[16] or a securitized asset fund) with substantially similar investment policies, objectives, or strategies to those of the private fund. This will generally include master-feeder structures and parallel funds, as well as some funds of one,[17] and other funds with overlapping, but not identical, strategies. Because the definition uses a disjunctive formulation—in

[16] While not entirely clear from the Adopting Release, we expect this second carve-out is intended to capture business development companies regulated under the Investment Company Act.

[17] In general, the SEC indicated that a fund of one would be considered a potential "pool" for this purpose under the same circumstances that such a fund would be considered a "private fund" for purposes of the "private fund adviser" exemption in Section 203(m) of the Advisers Act. An example would be a fund that seeks to raise capital from multiple investors but has only a single, initial investor for a period of time or a fund in which all but one of the investors have redeemed their interests. *See* Adopting Release at footnote 864 (citing Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 (June 22, 2011) [76 FR 39645 (July 6, 2011)] at 78-79).

contrast to the marketing rule's conjunctive formulation for a "related portfolio"—this concept is intentionally quite expansive.

The Preferred Treatment Rule provides two narrow exceptions to the ban on preferential liquidity rights:

1) If the right to redeem is necessary to comply with any US or non-US law, rule or regulation to which the investor, the private fund, or the similar pool of assets is subject; or
2) If the adviser has provided the same redemption rights to all other existing investors and will continue to offer such redemption rights to future investors in the same private fund or similar pools of assets.

The Adopting Release explicitly notes that an investor's internal policies or procedures would not qualify under the first exception. Moreover, under the second exception, an adviser must offer the same redemption rights to other investors without qualification, such as by reference to commitment or investment size or affiliation.

<u>Practice Notes</u>:

Legal Requirements. Because the exception from the prohibition on liquidity rights is premised on whether there is a legal requirement that applies, we expect there may be protracted discussions between investors and advisers regarding whether a particular liquidity requirement is effectively a *preference* stemming from law, or a *requirement* under the law (including with respect to regulated investors, such as banks, and benefit plan investors).

Multi-Share Class Funds. The other exception, for rights provided to other investors *without qualification* means that if a particular share class provides preferential liquidity (e.g., shorter lock-up or notice periods or more frequent liquidity), such share class cannot have a minimum investment higher than other share classes, or other restrictions on availability.

The ban on preferential information also contains an exception if the adviser offers such information to all investors in the same private fund or similar pools of assets at the same (or substantially the same) time. Notably, the ban on preferential information does not recognize an exception for investor-specific circumstances—e.g., situations where investor rights are based on an investor's unique circumstance such as ERISA reporting requirements or tax-related information requirements.

These first two aspects of the Preferential Treatment Rule:

- Apply not just to the investors in a private fund but also investors in similar pools of assets;
- Focus on whether the granting of a right would, in the reasonable opinion of the adviser, have a material negative effect on the other investors in the fund or similar pool of assets; and
- Apply to any form of arrangement or agreement (not just written side letters) between investors and an adviser, such as a limited partnership agreement (or, in the case of preferential

information, would even apply to oral or other communications between an adviser and an investor).

The Adopting Release states that the granting of preferential terms is generally a sales practice and conflict of interest that is contrary to the public interest. The Adopting Release cites examples where the adviser may be motivated to provide certain investors preferential terms whereby the preferred investors may take actions to the detriment of the other investors not receiving the information—such as acting on information regarding an underperforming fund or asset, or acting on information regarding a well-performing asset. In such situations, investors with access to information could mitigate losses by redeeming ahead of other investors or potentially front-run the fund.[18]

The Preferential Treatment Rule is likely to affect an adviser's ability to selectively:

- Provide advance notice of, or liquidity rights related to, key person events or bad actor events involving an adviser or its related persons; or
- Exercise the adviser's authority to waive any requirements associated with an investor withdrawal or redemption (e.g., notice period or minimum or maximum withdrawals).

This rule also may apply to certain special redemption rights that are occasionally granted to certain investor groups to mitigate certain material adverse tax consequences unique to such investor groups. Moreover, in the context of an open-end fund, a special redemption right granted to the sponsors to provide liquidity to address tax liabilities might be regarded as preferential redemption rights, which are not allowed under this new rule. We also believe that an off-cycle, accelerated withdrawal by an adviser or its related persons in connection with its receipt of incentive compensation paid in fund interests (rather than cash) would likely not be permitted under this aspect of the Preferential Treatment Rule because the same liquidity rights would not be offered to any other investors.

ii. Certain Preferential Treatment Permitted with Disclosure

The second part of the Preferential Treatment Rule (Rule 211(h)(2)-3(b)) prohibits an adviser to a private fund from, directly or indirectly, providing any preferential treatment to any investor in the private fund unless the adviser provides certain pre- and post-investment notices to prospective and current investors in the same private fund.

A prospective investor must be provided, prior to its investment, specific information regarding any preferential treatment related to any "material economic terms" provided to other investors in the same private fund. In addition, current investors must be provided disclosure of all preferential treatment (A) "as soon as reasonably practicable" (i.e., generally within four weeks) following (1) for an illiquid fund, the end

[18] The Adopting Release cites a 2020 Risk Alert from the Division of Examinations that identifies this as primarily an issue of inadequate disclosure. *See* OCIE National Examination Program Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

of its fundraising period and (2) for a liquid fund, the investor's investment and (B) provided since the last disclosure, on an annual basis.

iii. Material Economic Terms

Pre-investment disclosure of preferential "material economic terms" must describe specifically the preferential treatment. The Adopting Release makes clear that, in the SEC's view, disclosure of the mere fact that other investors are paying lower fees does not meet the required specificity threshold; rather, advisers are required to disclose the lower fee terms, including the applicable rate (or range of rates).[19]

Although the SEC did not offer a comprehensive list, the SEC explained that material economic terms consist of "those terms that a prospective investor would find most important and that would significantly impact its bargaining position (*i.e.*, material economic terms, including, but not limited to, the cost of investing, liquidity rights, fee breaks, and co-investment rights)."[20] Lower fee arrangements would qualify, including preferential economics granted to investors that invest in multiple products under a sponsor's general fee policy (i.e., "relationship pricing"). Preferential redemption rights granted to an investor based on the exception that they are required by applicable laws, rules, regulations, or orders of any relevant governmental authority would also likely qualify.

With respect to co-investment rights, the SEC further elaborated:

> Co-investment rights will generally qualify as a material, economic term to the extent they include materially different fee and expense terms from those of the main fund (*e.g.,* no fees or no obligation to bear broken deal expenses). Even if co-investment rights do not include different fee and expense terms, and for example, are offered to provide an investor with additional exposure to a particular investment or investment type, investors often negotiate for those rights and give up other terms in the bargaining process in order to secure access to co-investment opportunities. As a result, co-investment terms generally will be material given their impact on an investor's bargaining position.[21]

In addition to the foregoing material economic terms, sponsors and their counsel will be responsible for determining whether any other preferential terms require pre-investment disclosure, such as excuse/exclusion rights, limitations of liability (including indemnification), expense caps, and/or changes to the overall investment strategy. Importantly, there is no carve-out for terms provided due to an investor's specific legal, regulatory or tax status. The SEC believes that provision of these additional disclosures will enable investors to make more informed business decisions, including how preferential

[19] Adopting Release at page 293.

[20] Adopting Release at page 290.

[21] Adopting Release at footnote 882.

terms granted to other investors may negatively impact their investments, including with respect to conflicts of interest and compliance costs.

The Preferential Treatment Rule requires disclosures that go well beyond current market practice, which generally consists of disclosing (1) to prospective investors in the private placement memorandum the general types of side letter terms that the adviser may grant, and (2) to current investors with "most-favored nations" ("**MFN**") rights the specific terms available for MFN election.

This new requirement to provide specific disclosure to all investors prior to their investment could significantly increase the burden on advisers, particularly those sponsors with numerous side letters, and may cause delays to closing. Investors may use the information disclosed to negotiate better terms up front, potentially further delaying closing and requiring another round of pre-investment disclosures. Indeed, this may prompt some investors to take a "wait-and-see" approach, intentionally coming into the fund at a later closing in order to assess economic terms agreed in prior closings.

Further complicating matters, many hedge funds have been in existence for many years, even decades, with thousands of side letter provisions that will need to be reviewed for material economic terms and ultimately provided post-closing. These changes are likely to significantly increase operational costs for hedge fund advisers that permit side letters, which typically approach the MFN process differently, often limiting MFN election rights to a specific time period (e.g., two to three years from the investor's closing), with the election period often synced to a corresponding redemption lock-up.

In general, the net effect of these disclosure requirements may well be to reduce the prominence and ubiquity of side letters, particularly for smaller investors with less bargaining power, and drive sponsors to incorporate certain material economic terms, such as management fee rates based on commitment size, in fund governing documents. It will also necessarily increase costs that will likely ultimately be borne by the investors.[22]

iv. Post-Investment Disclosure

The post-investment disclosure regime is intended to be comprehensive—the SEC cites exceptions to the confidentiality obligation as an example. Similar to pre-investment disclosures, advisers may comply with post-investment disclosures by providing copies of side letters and similar agreements (with identifying information redacted) or written summaries that specifically describe the preferential treatment.[23] Disclosure of names or types of investors is not required, and the SEC is not prescribing the method of delivery, citing electronic, data room, and mail as examples. As noted above, such disclosures must be provided on a different schedule depending on whether the fund is a "liquid fund" or an "illiquid fund,"

[22] To the extent such costs are considered "regulatory" or "compliance" costs, they would need to be properly disclosed under the Restricted Activities Rule (in addition to being generally authorized under the fund's governing documents).

[23] Adopting Release at page 293.

i.e., "as soon as reasonably practicable" following the investor's investment, or following the end of the fundraising period, respectively, as well as on an annual basis thereafter. While funds that are not admitting new investors or providing side letters are not subject to the annual disclosure requirement (as long as they have not renegotiated any existing side letters and thus provided new preferential treatment not previously disclosed), note that the rule captures preferential terms granted to transferees in connection with investor transfers.

v. Investors Entitled to Disclosures

The post-investment disclosure obligations require the adviser to "distribute" disclosure of all preferential treatment to current investors in the same private fund, and the definition of "distribute" includes a look-through requirement for an investor that is a pooled investment vehicle that is controlling, controlled by, or under common control with the adviser or its related persons.

These post-investment disclosure obligations do not explicitly apply to preferential treatment provided to investors in a similar pool of assets, because the rule specifically refers to disclosure to investors in the same private fund. While an argument could be made that material economic terms received by parallel fund investors need not be provided to, for example, prospective main fund investors, we anticipate that the SEC will expect the same notices to investors that participate in the same fund complex—namely parallel funds and alternative investment vehicles that invest alongside the main fund.

Practice Notes:

Preferential Treatment is not Limited to Legally Enforceable Contracts. Preferential treatment is most commonly granted in side letters, but may also be granted in other forms. First, advisers should consider providing copies of master fund, parallel fund, alternative investment vehicle, and feeder fund agreements to all current investors, regardless of the actual legal entity in which they invest, either pre- or post-investment depending on whether such agreements include material economic terms. Second, advisers should consider whether any other preferential treatment has been provided, such as in confirmation letters or otherwise, as well as issues related to oral or other informal methods of disclosing information that would trigger the application of the first part of the rule.

Additional Investments. Pre-investment disclosures must also be provided to existing investors before they make additional investments in the same fund, including any material economic terms granted since the investor's initial (or most recent) investment.

Extensive Disclosures for Proprietary Funds-of-Funds. Given the "look-through" requirement that applies to pooled investment vehicles that are controlled, controlled by, or under common control with the adviser or its related persons ("affiliated funds"), a fund-of-funds that invests in other funds managed by the same adviser will be required to distribute preferential treatment disclosures of every underlying fund to all investors in the fund-of-funds.

Initial Extensive Disclosure Requirement for Existing Funds. On the applicable compliance date, advisers to existing funds will be required to begin complying with the disclosure requirement for all of their existing private funds, without regard to where they are in their current lifecycle—even if it is a closed-end fund that has completed its investment period or is in liquidation. We do not believe this is an "unintended consequence" of the rule, but rather the explicit intent of the SEC to increase transparency to investors as they consider future investments in new funds from advisers they have previously invested with.

IV. Additional Requirements for Registered Investment Advisers

A. Requirements Related to Adviser-Led Secondary Transactions

The Adviser-Led Secondaries Rule imposes new requirements on all RIAs pertaining to "adviser-led secondary transactions," as such term is defined.[24] The Final Rules broadly define these as transactions initiated by the adviser or any of its related persons that offer the private fund's investors the *choice* between: (1) selling all or a portion of their interests in the private fund, and (2) 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. Common examples of such transactions include "continuation funds," certain fund restructurings and stapled secondaries (e.g., the adviser causing the fund to sell substantially all fund assets to a new vehicle managed by the adviser), and single or multiple asset transactions (e.g., the adviser causing the fund to sell one or more assets to a new vehicle managed by the adviser). Other common variants include strip sales and combinations of the foregoing transactions.

In connection with a covered secondary transaction, the Adviser-Led Secondaries Rule requires all RIAs to:

i. Obtain a fairness opinion or valuation opinion from an "independent opinion provider";[25]

ii. Prepare a written summary of any "material business relationships"[26] that the adviser or its related persons has (or had) with the independent opinion provider within the two-year period prior to the issuance of such opinion; and

iii. Distribute both the opinion and written summary required under clauses (i) and (ii) above to all investors in the private fund prior to the due date of the election form for such transaction.[27]

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[24] *See* Final Rule 211(h)(2)-2.

[25] Defined as a person that provides fairness opinions or valuation opinions in the ordinary course of its business and is not a related person of the adviser. *See* Rule 211(h)(1)-1.

[26] Whether a business relationship is material requires a facts and circumstances analysis; however, audit, consulting, capital raising, investment banking, and other similar services would typically meet this standard. *See* Adopting Release at page 199.

[27] The SEC defined "election form" as a written solicitation distributed by, or on behalf of, the adviser or any related person requesting private fund investors to make a binding election to participate in an adviser-led secondary transaction. *See* Rule 211(h)(1)-1.

As described by the SEC, the purpose of the Adviser-Led Secondaries Rule is to create an effective deterrent to conflicts and excessive compensation, as well as to provide investors with important information regarding valuation and conflicts at the time they make a binding decision to participate in the transaction.[28]

Whether the adviser or its related person initiated a secondary transaction thus triggering the new rules requires a facts and circumstances analysis. However, the SEC clarified that an adviser generally would not be considered to "initiate" such a transaction if the adviser assists an investor with a secondary sale of such investor's interest in the fund following an unsolicited request by that investor.[29] The SEC also explained that the Final Rules would not generally apply to cross-trades (including rebalancings between parallel funds and "season and sell" transactions between parallel funds). In addition, unlike the Proposal, the Adviser-Led Secondaries Rule does not apply to tender offers or other transactions as long as the fund investors are not faced with the choice between (A) selling all or a portion of their interests and (B) converting or exchanging all or a portion of their interests into a stake in a new secondary vehicle. For example, the rule would not apply to transactions where the choice is between (x) selling all or a portion of an investor's interest in the private fund and (y) simply continuing to hold the investor's existing fund interest.

We believe that market standards already result in many sponsors to seek a fairness opinion or valuation opinion as a best practice for adviser-led secondaries, though, historically, the timing for delivery of such opinion has not always been prior to the investor consent solicitation. Specifically, we have seen it was not uncommon for the opinion to be obtained immediately prior to closing, following the final price negotiations and closing adjustments. The SEC, however, has taken the position that informed investor consent requires the opinion prior to such consent, even if the final closing price may be subject to adjustments under the transaction documents.

It remains to be seen how much impact on pricing the delivery of opinions will have on secondary transactions. We expect, however, that expenses for transactions that have not historically relied on such opinions (for example, where a third-party bid establishes the price) will result in increased expenses, and that ultimately such expenses will be borne by the fund's investors.[30]

B. Requirement to Deliver Quarterly Reports

Currently, the Advisers Act does not require advisers to provide reports or statements to their advisory clients. Under the Quarterly Statement Rule, however, RIAs to private funds will be required to provide quarterly statements to investors within certain time periods after each fiscal quarter end that describe

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[28] *See* Adopting Release at page 201.

[29] Adopting Release at page 190.

[30] We note that to the extent such expenses are considered "compliance" expenses, they will need to be specifically disclosed as required under the Restricted Activities Rule.

fees and expenses of the fund and its portfolio companies and include specified performance metrics. The quarterly statements, which include requirements similar to Form N-1A for mutual funds, will be subject to the anti-fraud provisions of the federal securities laws and related record-keeping requirements. The requirements for the quarterly statements are summarized below.

In several parts of the Adopting Release, the SEC reiterated its overall belief that private fund investments can be opaque and that the quarterly statements portion of the Final Rules is meant to increase transparency for private fund investors and inform their investment decisions.[31] The SEC also believes that the quarterly statement requirements will provide a baseline level of information that private fund investors should receive with respect to their investments and that the standardized reporting requirements can better assist private fund investors in comparing and interpreting fees and performance metrics across private fund products that have similar investment strategies.[32] The SEC acknowledged in the Adopting Release that the new reporting requirements are expected to increase regulatory and compliance costs, but the SEC believes these costs are justified in light of what the SEC believes are the perceived benefits under the Quarterly Statement Rule.[33]

Practice Note: While private funds may seek to rely on their existing reporting infrastructure, we anticipate that the Quarterly Statement Rule will require private fund RIAs to re-evaluate and expand their current processes and that implementation of these reporting requirements will raise a number of challenges. For example, illiquid funds that pursue private equity, value-add, and opportunistic real estate or venture capital strategies, in particular, will likely face difficulty obtaining the necessary reporting information for their portfolio investments and estimating the unrealized portions of their portfolio. It is possible this will drive up the costs for certain assets. We expect that private funds may require the underlying portfolio companies to agree to provide the required quarterly information as a condition of the fund's investment, thus layering an additional cost and negotiating hurdle at the asset level. Finally, older funds may have difficulty providing the requisite information for all required periods, and the costs will tend to exacerbate end-of-term costs when a fund is proceeding toward wind-down.

i. Fee and Expense Disclosure

The quarterly statements will need to include a table listing the following fund-level expenses: (A) a detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or its related persons by the private fund during the reporting period (i.e., the adviser compensation requirements); (B) a detailed accounting of all other fees and expenses allocated to or paid by the private fund during the reporting period (i.e., the fund expenses requirements); and (C) the amount of any

[31] *See, e.g.*, discussion in Adopting Release at page 104.

[32] *Id.;* Adopting Release at page 68.

[33] Adopting Release at pages 65-66.

unapplied offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons. In addition, RIAs to private funds will need to disclose a detailed accounting of all portfolio investment compensation allocated or paid to either the RIA or any of its related persons by a portfolio investment during the reporting period.[34] A more detailed discussion of each of these requirements follows.

1) Adviser Compensation

Within a table, the quarterly statements are required to show a detailed accounting of all compensation allocated or paid to either the RIA *or* any of its related persons by the private fund during the reporting period, with *separate* line items for each category of allocation or payment reflecting the total dollar amount. This section is designed to capture all forms and amounts of compensation, fees, and other amounts allocated or paid to these persons, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and "performance-based compensation."[35]

- Noting that many advisers conduct their advisory operations through multiple affiliated entities, the SEC included compensation paid to an adviser's "related persons" in an attempt to capture the various entities and personnel that an adviser may use to provide advisory services to, and receive compensation from, private fund clients.[36]
- RIAs are *not* permitted to exclude "de minimis" expenses, group or consolidate smaller expenses into broad categories or label expenses as "miscellaneous" to avoid the detailed reporting requirements. These same rules apply to the Fund Expenses as discussed in Section V(b)(i)(2) below.

Practice Note: Although the Quarterly Statement Rule includes certain specific examples of adviser compensation that should be reported on a line-item basis, this is not meant to be an exclusive list. Certain private funds may pay other forms of compensation to the RIA or related persons that may not be specifically listed but could still technically be compensation meant to be disclosed. Thus, RIAs should be mindful not to inadvertently exclude disclosing certain novel or non-traditional forms of adviser compensation fitting within the definition (the Adopting Release notes that the requirement is meant to encompass the various and evolving forms of adviser compensation across the private funds industry).[37]

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[34] The term "portfolio investment" is defined as "any entity or issuer in which the private fund has directly or indirectly invested." It is intended to capture any entity or issuer in which the private fund holds an investment including through holding companies, subsidiaries and other intermediary vehicles, and will often require advisers to make a good faith determination of which entity or entities constitute the "portfolio investment."

[35] "Performance-based compensation" is defined under the Final Rules as "allocations, payments, or distributions of capital based on a private fund's (or its investments') capital gains, capital appreciation, and/or profit."

[36] Adopting Release at pages 79-80.

[37] Adopting Release at page 82.

2) Fund Expenses

The table will also be required to show a detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period, other than those disclosed as adviser compensation, with separate line items for each category of fee or expense reflecting the total dollar amount. The Quarterly Statement Rule is meant to broadly capture all such fund fees and expenses, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses.[38]

- Similar to the adviser compensation requirements, the Adopting Release emphasized that with respect to private fund expenses, it would not be sufficient to report a single line item for "fund expenses" as the SEC believes that this would obfuscate the nature and/or extent of the fees and expenses borne by the fund. Instead, an RIA needs to include a breakdown of, for instance, insurance premiums, administrator fees, audit fees, etc., during the reporting period.[39]
- To the extent that a fund expense also could be characterized as adviser compensation, RIAs are required to disclose such payment or allocation as adviser compensation as opposed to a fund expense in the quarterly statement. As an example, the Adopting Release noted that an RIA or its related persons may provide certain non-advisory services to the fund (such as consulting, legal, or back-office services) and that the Quarterly Statement Rule requires RIAs to disclose such expenses, whether advisory or non-advisory, as part of the detailed accounting of adviser compensation.[40]

Practice Note: Given the detailed, line-item disclosure requirements, RIAs need to ensure their processes and data reporting collection methods are sufficiently robust to identify and classify fund expenses into appropriate categories for reporting purposes. Advisers should evaluate whether they have sufficient resources available, which may present challenges to advisory operations that have traditionally categorized fund expenses into broader categories.

3) Offsets or Rebates

The table in the quarterly statements is required to show adviser compensation and fund expenses both before *and* after the application of any offsets, rebates, or waivers. Specifically, the Quarterly Statement Rule requires an RIA to present the dollar amount of each category of adviser compensation or fund expense before *and* after any such reduction for the applicable reporting period. In addition, RIAs have to disclose

[38] Adopting Release at pages 83-87.

[39] Adopting Release at page 84.

[40] Adopting Release at page 87.

the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future adviser compensation.[41]

- As an example, the Adopting Release noted that certain fund governing documents require advisers to offset certain expenses against the management fee on a dollar-for-dollar basis (i.e., management fee offsets). The management fee will need to be listed both before and after the application of any fee offset.[42]
- The SEC believes that these requirements will provide private fund investors with greater transparency into advisers' fee and expense practices, particularly with respect to how offsets, rebates, and waivers affect an adviser's overall compensation as well as the sources of compensation.

4) Portfolio Investment-Level Disclosure

The Quarterly Statement Rule also requires RIAs to disclose, in a separate table, a detailed accounting of all "portfolio investment compensation" allocated or paid to the adviser or any of its related persons by each "covered portfolio investment" during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented both before and after the application of any offsets, rebates, or waivers.[43]

- Portfolio investment compensation is defined as "any compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the portfolio investment attributable to the private fund's interest in such portfolio investment." However, portfolio investment compensation does not include distributions representing profit or return of capital in respect of a fund's ownership or other interest in a portfolio investment (e.g., dividends).
- A covered portfolio investment is defined as "a portfolio investment that allocated or paid the adviser or its related persons portfolio investment compensation during the reporting period."[44]

Similar to the fund-level disclosure, this new table is intended to improve transparency for investors and also highlight potential conflicts of interest of the adviser and its related persons.

Practice Note: Certain advisers may be part of larger advisory organizations with multiple global affiliates that operate independently of one another and may have information barriers in place between such affiliates for various reasons. Unfortunately, the Quarterly Statement Rule did not specifically exclude operationally independent affiliates from the relevant definitions, so affected RIAs will need to implement

[41] Adopting Release at pages 87-89.

[42] Adopting Release at page 87.

[43] Rule 211(h)(1)-2(c) and Adopting Release at pages 89-100.

[44] *See* Rule 211(h)(1)-1.

internal reporting procedures to ensure that applicable compensation allocated or paid to the adviser or its related persons by each covered portfolio investment can be reported in the table. This issue is likely to be particularly exacerbated for credit funds, where it is likely to be impossible or impracticable to request information from portfolio companies, and accordingly information will need to be supplied by affiliates.

5) Calculations and Cross-References to Organizational and Offering Documents

As part of the above reporting, the Quarterly Statement Rule requires that each quarterly statement include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated. This disclosure will generally require RIAs to describe, among other things, the structure of, and the method used to determine, any performance-based compensation set forth in the quarterly statement (such as the distribution waterfall, if applicable) and the criteria on which each type of compensation is based (e.g., whether such compensation is fixed, based on performance over a certain period, or based on the value of the fund's assets).[45]

Additionally, the quarterly statement *must* include cross-references to the relevant sections of the fund's organizational and offering documents that set forth the applicable calculation methodology. The SEC believes that this will better enable an investor to confirm that the adviser calculated the disclosed fees in accordance with the fund's governing documents and to identify whether the adviser deducted or charged incorrect or unauthorized amounts.[46]

Practice Notes: Inclusion of the calculation methodology is similar to other recent SEC rulemaking (see, e.g., the hypothetical performance disclosures under the Advisers Act Marketing Rule (Rule 206(4)-1)), so RIAs are likely already familiar with some of the challenges in drafting clear and sufficient disclosures summarizing the relevant calculation methodologies and criteria used. While the Quarterly Statement Rule does not include specified calculation methodologies, advisers should adopt a reasonable, good-faith (and consistent) methodology that can be substantiated as part of their books and records.

In light of the requirement to include cross-references to governing documents, RIAs should also implement a process to update, if necessary, such quarterly statement references in the event governing document provisions are amended or changed.

[45] Rule 211(h)(1)-2(d).

[46] Adopting Release at page 102.

ii. Performance Disclosure

Secondarily, the Quarterly Statement Rule requires quarterly statements to include standardized fund performance information that the SEC believes will assist investors in monitoring and assessing their investments.[47] It includes different performance metrics for "liquid funds" and "illiquid funds" but is generally intended to enable investors to compare their various private fund investments to determine what to do holistically with their overall investment portfolio. These definitions are new and do not rely on pre-existing definitions in Form ADV, Form PF, or the Volcker Rule.

The Adopting Release noted that non-paying adviser and affiliate private fund interests should generally be excluded when calculating performance for the quarterly statements. Since such interests generally are not subject to fees (e.g., management fees or carried interest), the SEC believes that performance of such non-fee paying interests is not necessarily relevant for other investors and would serve to increase net returns in a way that could be misleading.[48] In addition, the Adopting Release noted that so long as the required performance information is included, advisers are permitted to include other performance metrics in the quarterly statements, but cautioned that such additional disclosure might be subject to other rules and regulations, such as the Advisers Act Marketing Rule (Rule 206(4)-1).

> Practice Note: This portion of the Quarterly Statement Rule is subject to a strict liability standard. Given its specific requirements with respect to content and formatting, we expect these will represent "low-hanging fruit" for the SEC Examinations and Enforcement staff to assert technical violations against non-complying RIAs.

1) Illiquid vs. Liquid Funds

An "illiquid fund" is a private fund that: (A) is not required to redeem interests upon an investor's request; and (B) has limited opportunities, if any, for investors to withdraw before termination of the fund. A "liquid fund," conversely, is defined as any private fund that is not an illiquid fund.[49] The Adopting Release noted that generally, if a private fund allows voluntary redemptions/withdrawals, it is a liquid fund (such as many hedge funds); while an illiquid fund would generally be a private fund that does not allow voluntary redemptions/withdrawals other than in exceptional circumstances, such as in response to regulatory events (i.e., most closed-end funds).[50] While recognizing that certain types of hybrid private funds or evergreen funds may have characteristics of both liquid and illiquid funds, the SEC declined to provide a

[47] Adopting Release at page 104.

[48] Adopting Release at page 109.

[49] Rule 211(h)(1)-1.

[50] Adopting Release at page 112.

third "hybrid" fund category, believing it would cause confusion.[51] In the absence of further guidance, hybrid-like funds will need to evaluate themselves as to which category their fund would come under.

Practice Note: An RIA will need to maintain documentation supporting its determination as to why its particular private funds are either "illiquid" or "liquid" funds (see discussion of recordkeeping requirements in Section IV.B(vi) below).

2) Liquid Fund Performance Disclosures

RIAs to liquid funds need to disclose the following information: (A) the fund's annual net total returns for each fiscal year over the past 10 fiscal years or since inception (whichever time period is shorter); (B) the fund's annual net total returns over the one-, five-, and 10-fiscal year periods, as applicable; and (C) the fund's cumulative net total return for the current fiscal year as of the most recent fiscal quarter covered by the quarterly statement.[52] Each period must be displayed with equal prominence.[53]

Practice Note: Similar to the Advisers Act Marketing Rule, an RIA can include other performance periods or metrics in the quarterly statements (e.g., the gross versions of such figures) provided the required periods and metrics are shown with appropriate prominence and the inclusion of such additional information complies with the federal securities laws' anti-fraud provisions and other applicable law.

3) Illiquid Fund Performance Disclosures

RIAs to illiquid funds need to provide investors with a statement of contributions and distributions for the fund and disclose the following performance measures, shown since inception of the fund and computed with *and* without the impact of any fund-level subscription facilities: (A) gross internal rate of return ("**IRR**") and gross multiple of invested capital ("**MOIC**"); (B) net IRR and net MOIC; and (C) gross IRR and gross MOIC for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.[54]

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[51] Adopting Release at page 114.

[52] Rule 211(h)(1)-2(e)(2).

[53] Adopting Release at page 118.

[54] Notably, the Adopting Release acknowledged that separately calculating *net* figures for realized and unrealized investments "could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees, expenses, and adviser compensation between the realized and unrealized portions of the portfolio …. [which] have the potential to erase the benefits that net performance measures would provide." Adopting Release at page 140.

- The Quarterly Statement Rule includes specific standardized definitions for the IRR and MOIC components of the above performance disclosure requirements.[55]
- While the Quarterly Statement Rule requires an RIA to include performance measures for the illiquid fund through the end of the quarter covered by the quarterly statement, the SEC recognizes that certain funds may need information from portfolio investments and other third parties to generate performance data and thus may not have the necessary information prior to the distribution of the quarterly statement. To the extent quarter-end numbers are not available at the time of distribution of the quarterly statement, the performance measures should be included through the most recent practicable date, which the SEC generally believes would be through the end of the quarter immediately preceding the quarter covered by the quarterly statement.[56]

Practice Note: RIAs should make reasonable, good-faith efforts to procure third-party information to provide the most up-to-date quarterly performance information in the applicable quarterly statement. We expect that the SEC Examination and Enforcement staff will heavily scrutinize RIAs that consistently provide dated performance information in quarterly statements by claiming an inability to receive timely information from third parties (see prior practice note above on "low-hanging fruit" compliance and enforcement risk for technical violations of the Quarterly Statement Rule).

- The requirement to present performance information with and without the impact of fund-level subscription facilities[57] is consistent with the SEC staff's long-standing concern that the use of these facilities, without proper disclosure, can artificially inflate the internal rates of return reported to fund investors.

Practice Note: This requirement will require advisers to make certain assumptions regarding when capital would have been called if the facility had not been used, and also to account for fees and expenses associated with the use of a facility, such as interest expenses, when presenting performance figures.

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[55] Rule 211(h)(1)-1 defines IRR as the discount rate that causes the net present value of all cash flows throughout the life of the private fund to be equal to zero. MOIC is defined as (i) the sum of (A) the unrealized value of the illiquid fund; and (B) the value of all distributions made by the illiquid fund; (ii) divided by the total capital contributed to the illiquid fund by its investors. A net IRR is defined as the internal rate of return that is calculated net of all fees, expenses and performance-based compensation borne by the private fund, while net MOIC is defined as a multiple of invested capital that is calculated net of all fees, expenses and performance-based compensation borne by the private fund.

[56] Adopting Release at page 124.

[57] Rule 211(h)-1 defines fund-level subscription facilities as "any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness incurred by the private fund that is secured by the unfunded capital commitments of the private fund's investors." In addition, "unfunded capital commitments" are defined as committed capital that has not yet been contributed to the private fund by investors, and "committed capital" as any commitment pursuant to which a person is obligated to acquire an interest in, or make capital contributions to, the private fund.

These assumptions should be sufficiently disclosed to investors in the quarterly statement itself so investors are able to analyze the assumptions made and weigh their impact on performance.

- The Quarterly Statement Rule also requires RIAs to include *prominent* disclosure of the criteria used and assumptions made in calculating the performance. The SEC believes that such requirement will help private fund investors understand how the performance is calculated and help provide useful context for the presented performance metrics.

Practice Note: These calculation disclosures *must* be provided with reasonable prominence in the four corners of the quarterly statement itself and cannot be relegated to a separate document, website hyperlink, QR code, or other separate disclosure.[58] This is consistent with how the SEC staff treats comparable disclosures in other recent rules (such as hypothetical performance calculation and assumption disclosure in the Advisers Act Marketing Rule) and in a recent SEC enforcement action.[59]

iii. Preparation and Distribution of Quarterly Statements

Timing of distribution of quarterly statements under the Quarterly Statement Rule depends on the type of private fund and the relevant quarter to which the quarterly statement relates.

- For private funds that are not funds of funds, quarterly statements must be prepared and distributed to investors within 45 days after the first three fiscal quarter ends of each fiscal year and within 90 days after the end of each fiscal year.
- For funds of funds, quarterly statements must be prepared and distributed within 75 days after the first three fiscal quarter ends of each year and within 120 days after the end of each fiscal year.

Practice Note: Although the term "fund of funds" is not defined under the Quarterly Statement Rule, language in a footnote within the Adopting Release indicates that a fund of funds would include a private fund that invests substantially all of its assets in the equity of private funds that do *not* share its same adviser and, aside from such private fund investments, holds only cash and cash equivalents and instruments acquired to hedge currency exposure.[60] This is similar to the approach taken in responses to

[58] Adopting Release at page 141.

[59] *See* In the Matter of Titan Global Capital Management USA LLC, Investment Advisers Act Release No. 6380 (August 21, 2023), available at https://www.sec.gov/files/litigation/admin/2023/ia-6380.pdf. For a further discussion of this action, please see our prior Legal Update on the matter at https://www.mayerbrown.com/en/perspectives-events/publications/2023/08/us-sec-brings-first-marketing-rule-action-a-return-to-rulemaking-by-enforcement.

[60] *See* Adopting Release at footnote 421 and accompanying text.

current FAQs to the Custody Rule with respect to the extension of its audited financial distribution deadlines for pooled investment vehicles,[61] but is obviously much more narrow than the definition of "fund of funds" used for purposes of Form ADV, Schedule D, Section 7.B.(1) Question 8(a), which includes a fund that invests 10% or more of its total assets in other pooled investment vehicles (without regard to whether they are advised by the same adviser or a related person). The SEC's reference to the criteria from the Custody Rule FAQ suggests an intent to apply a more limited definition.

- In each instance, an adviser must prepare and distribute the required quarterly statement within the applicable period, unless another person (such as another adviser to the fund, or a fund administrator) prepares and delivers such quarterly statement. *S*uch other person must still provide the required information, and the adviser will remain responsible for providing to investors any required information that is not included in the statement furnished by such other person.[62]

Practice Note: Sub-advisers to private funds will need to coordinate closely with the fund's primary adviser to ensure these statements are delivered. Sub-advisers to funds managed by ERAs or other unregistered advisers may face significant challenges in preparing or causing the fund's primary adviser to prepare and distribute quarterly statements meeting the requirements of the rule. In contrast to the Audit Rule discussed in Section IV.C below, the Quarterly Statement Rule does not provide any form of relief with respect to a fund not controlled by the RIA.

- For a newly formed private fund, the Quarterly Statement Rule requires a quarterly statement to be prepared and distributed beginning after the fund's second full quarter of generating operating results.
- The Adopting Release noted that there may be certain reasonable unforeseen circumstances that might cause an RIA to miss the required timing deadline under the Quarterly Statement Rule and stated that this would not provide a basis for an enforcement action so long as the adviser reasonably believed that the quarterly statement would be distributed by the applicable deadline and the adviser delivers the quarterly statement as promptly as practicable.[63]

Practice Note: Any assertion of this relief would thus likely be limited to unexpected emergency circumstances and should be reasonably documented by the RIA.

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[61] *See, e.g.* FAQ to Question V1.7 at https://www.sec.gov/divisions/investment/custody_faq_030510.

[62] *See* Adopting Release at footnote 422 and accompanying text.

[63] This largely mirrors the SEC staff's guidance with respect to unforeseen late deliveries of annual audited financial statements under the Custody Rule. *See, e.g.,* FAQ to Question V1.9 at https://www.sec.gov/divisions/investment/custody_faq_030510.

- An adviser generally will satisfy the requirement to "distribute" the quarterly statements when the statements are sent to all investors in the private fund. If an investor is a pooled vehicle that is in a control relationship with the adviser, the RIA must look through that pool (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure), to send the quarterly statements to investors in those pools.[64]
- The Adopting Release noted that RIAs could utilize data rooms to electronically distribute quarterly statements *provided* such electronic delivery satisfies existing SEC guidance regarding electronic delivery.[65] Thus, if an adviser places the quarterly statements in a data room without any notice to investors, advisers would *not* meet the distribution requirement under the rule. However, if the adviser notifies investors when the quarterly statements are uploaded to the data room within the applicable time period and ensures that investors have access to the quarterly statement included therein, the adviser would generally satisfy the distribution requirement.[66]

> Practice Note: To the extent an RIA relies on a data room distribution model that incorporates notices sent to email addresses previously provided by investors, the RIA should also have reasonable policies in place in the event it receives "bounce back" notices that an investor-provided email address is unexpectedly no longer valid (e.g., does it have alternative processes in place to distribute the statements to the relevant investor or to obtain corrected email addresses?).

iv. Consolidation Requirements

Under the Quarterly Statement Rule, advisers are required to consolidate reporting for similar pools of assets to the extent doing so provides more meaningful information to the private fund's investors and is not misleading.[67] As an example, the Adopting Release noted that feeder funds that invest substantially all of their assets in a master-feeder structure would generally provide investors with a single quarterly statement covering the applicable feeder fund and the feeder fund's proportionate interest in the master

[64] Adopting Release at pages 149-150.

[65] *See* Use of Electronic Media by Broker Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940, Release No. 34-37182 (May 9, 1996) [61 FR 24644 (May 15, 1996)]; *see also* Commission Interpretation: Use of Electronic Media, Release No. 34-42728 (Apr. 28, 2020) [65 FR 25843 (May 4, 2000)].

[66] Adopting Release at pages 150-151.

[67] Rule 211(h)(1)-2(f). The Adopting Release also noted that advisers generally should disclose the basis of any consolidated reporting in the quarterly statement (e.g., if the statement includes multiple entities and, if so, which entities and the methods used to calculate the amounts on the statement allocated from each entity) as well as disclose any important assumptions associated with consolidated reporting that affect performance reporting as part of the quarterly statement. Adopting Release at footnote 440 on page 151.

fund on a consolidated basis, so long as the consolidated statement provides more meaningful information to investors and is not misleading.[68]

v. Form and Content Requirements

The Quarterly Statement Rule also requires RIAs to use clear, concise, plain English in the quarterly statements.[69] By way of example, the Adopting Release explained that RIAs should generally use a font size and type that are legible and with reasonable margins and paper size; that any supplemental information not required by the Quarterly Statement Rule be as concise as practicable and not obscure or impede any required information; and that information be presented in a consistent format designed to facilitate review from one quarterly statement to the next.[70]

vi. Recordkeeping Requirements

Lastly, the SEC also adopted accompanying revisions to the Advisers Act's recordkeeping rule (Rule 204-2) requiring RIAs to:

- Make and retain a copy of any quarterly statement distributed to fund investors pursuant to the Quarterly Statement Rule, as well as a record of each addressee and the date(s) the statement was sent;
- Make and retain all records evidencing the calculation of payments, allocations, rebates, offsets, waivers, and performance listed on any quarterly statement delivered pursuant to the Quarterly Statement Rule; and
- Make and keep books and records substantiating the adviser's determination that a private fund client is a liquid fund or an illiquid fund pursuant to the Quarterly Statement Rule.

> Practice Note: RIAs should review and potentially may need to amend their current books and records policies and supporting documentation (such as recordkeeping matrices, if applicable) to include these newly adopted recordkeeping provisions. This represents another potential avenue for SEC Examination and Enforcement staff to assert technical violations of Rule 204-2 for advisers that inadvertently fail to maintain required books and records associated with these requirements.

C. Requirement to Obtain an Annual Audit

Under the Audit Rule, advisers registered with, or required to be registered with, the SEC are required to cause the private funds they directly or indirectly advise to undergo audits in accordance with the audit

[68] Adopting Release at pages 151-154.

[69] Rule 211(h)(1)-2(g)

[70] Adopting Release at pages 154-157.

and financial statement delivery requirements set forth in the Custody Rule. As a result, each of the following is required under the Audit Rule:

(i) The audit must be performed by an independent public accountant that meets the standards of independence in Rule 2-01(b) and (c) of Regulation S-X that is 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;

(ii) The audit must meet the definition of audit in Rule 1-02(d) of Regulation S-X;

(iii) The audited financial statements must be prepared in accordance with generally accepted accounting principles; and

(iv) The audited financial statements must be delivered to fund investors on an annual basis within 120 days of the fund's fiscal year-end and promptly upon liquidation of the fund.

The Audit Rule includes a limited exception for advisers that do not control (and are not under common control with) the private fund, so long as the adviser takes all reasonable steps to cause an audit to be performed, but is unsuccessful. In practice, we expect that this will be most applicable to sub-advisers not affiliated with the fund's primary adviser. Advisers that do not control (and are not under common control with) the private fund will be required to keep a record documenting steps taken by the adviser to cause a private fund client that it does not control (and is not under common control with) to undergo a financial statement audit that complies with the Audit Rule.

The SEC clarified how this rule applies to special purpose vehicles ("**SPVs**") that hold investments below a fund and may technically also be "private funds" because they rely on the relevant exceptions under the Investment Company Act. Consistent with prior guidance under the Custody Rule itself, the SEC clarified that an adviser may choose between two options: (1) treat an SPV as a separate client, in which case the rule applies to such SPV (including a requirement to distribute the SPV's audited financials to the fund's beneficial owners) or (2) treat the SPV's assets as assets of the fund, in which case such assets must be within the scope of the fund's mandatory audit.

Furthermore, the Final Rules also amended the books and records rule to require advisers to keep copies of audited financial statements and to document to whom such financial statements were sent and when.

> Practice Notes: Because the Audit Rule effectively incorporates the Custody Rule, it also should effectively incorporate the SEC and staff guidance regarding the Custody Rule (including, e.g., the ability of non-US-based funds to present financials other than under US GAAP (provided that they have been reconciled to US GAAP)). This also means that any changes to the Custody Rule (including under the current "Safeguarding Rule" proposal) will effectively be incorporated prospectively into the Audit Rule.

D. Requirement to Document Annual Compliance Review

The Final Rules amend the Compliance Rule to require all RIAs, including RIAs that advise "securitized assets funds" (such as CLOs) and RIAs that advise no private funds at all, to review and document in writing, no less frequently than annually, the adequacy of their compliance policies and procedures and the effectiveness of their implementation. The Adopting Release does not enumerate specific elements that advisers must include in the written documentation of their annual review. Rather, the SEC has suggested that the amended Compliance Rule is intended to provide flexibility and that the annual review should consider "any compliance matters that arose during the previous year, changes in the business activities, or changes to the Advisers Act or other rules and regulations that may impact that particular adviser."[71] The amended Compliance Rule does not require a specific format but rather allows an adviser to determine what would be appropriate for its own written documentation.

Furthermore, it is important to note that the SEC emphasized its position that claims of attorney-client privilege, work-product doctrine, and other similar protections over required records (including with respect to reviews and work prepared by compliance consultants engaged by outside counsel) are inconsistent with an RIA's obligations to produce documents promptly to the SEC and the staff's ability to conduct examinations.

V. Conclusion

The Final Rules clearly will have a significant impact on the private fund landscape, as fund sponsors and investors alike grapple with both the immediate changes and second order effects over the months and years to come. The SEC is showing no signs of slowing its current rulemaking agenda, and newly adopted rules, like these, have historically proven to be significant fodder for the SEC's examination and enforcement efforts.

[71] Adopting Release at page 301.