

February 16, 2022

# SEC Proposes Significant Rule Changes for Private Fund Advisers

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## Proposal Would Impose Substantial New Disclosure Obligations and Prohibitions on a Broad Range of Activities

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### SUMMARY

On February 9, 2022, the Securities and Exchange Commission (the “SEC”) voted 3 to 1<sup>1</sup> (Commissioner Peirce dissenting) to propose new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act)<sup>2</sup> that would impose significant new requirements on investment advisers to hedge funds, private equity funds and certain other private funds.<sup>3</sup> The proposal represents a significant expansion of the SEC’s regulation of private fund advisers and, if implemented as proposed, would fundamentally alter how private fund advisers and investors in private funds—typically institutional investors, pension plans and high-net-worth individuals—structure their relationships.

The proposed rules are intended to increase investors’ visibility into certain practices regarding fees, expenses and fund performance, increase disclosure around potential conflicts of interest and prohibit certain practices that the SEC believes has the potential to harm investors. As proposed, the amendments would:

- (1) require SEC-registered private fund advisers to:
  - prepare and distribute quarterly statements disclosing information on fund performance, fees and expenses;
  - obtain an annual audit by an independent public accountant for each private fund they manage;
  - distribute to investors a fairness opinion in connection with adviser-led secondary transactions and disclose certain material relationships between the adviser and the opinion provider;
- (2) prohibit all private fund advisers, including those that are not required to be registered with the SEC, from:

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- charging fees for unperformed services (e.g., accelerated monitoring fees) and fees associated with an examination or investigation of the adviser;
- seeking reimbursement, indemnification or exculpation for certain activities;
- reducing the amount of clawback for an adviser or its related persons by the amount of certain taxes;
- charging fees or expenses related to portfolio companies and broadly defined investments on a non-pro rata basis;
- borrowing from private fund clients; and
- providing certain types of preferential treatment to investors, unless such treatment is disclosed to all investors.

The SEC also proposed certain amendments to the Advisers Act compliance rule to require all registered advisers to provide written documentation of their annual review of compliance policies and procedures and to the books and records rule to require advisers to retain records to facilitate the SEC's compliance oversight. These amendments are aimed to facilitate compliance and assist examination staff.

If adopted, advisers would generally be required to comply with the proposed rules one year following its effective date. The proposal does not contain grandfathering provisions for existing private funds, complicating the rule's applicability to these existing funds, especially private equity and venture capital funds. If adopted in its current form, private fund advisers would be required to modify their practices and the terms of their existing private funds.

The SEC is seeking comment from the public on the proposal. Consistent with Chairman Gensler's approach on several other recent rulemaking initiatives, the comment deadline is accelerated, with comments due on April 11, 2022 or 30 days after the proposed amendments are published in the Federal Register, whichever is later.

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### BACKGROUND

According to the Release, during the almost 10-year period that the SEC has overseen private fund advisers, private funds have come to "play an increasingly important role in the financial system" and "continue growing in size, complexity, and number."<sup>4</sup> The industry has grown to over 5,000 registered advisers and \$18 trillion in private fund assets under management. Over this period, private funds investors have also become more diverse, and now include state and municipal pension plans, college and university endowments, non-profit organizations, and high-net-worth individuals, as well as those investors with exposure to private funds through private pension plans, endowments, feeder funds, foundations and certain other retirement plans. Given the impact of the industry on the financial system and investors, the SEC believes enhanced regulation is needed "to protect investors, promote more efficient capital markets, and encourage capital formation."<sup>5</sup>

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The Release identifies the SEC's particular concern with "problematic practices related to fees and expenses paid by private fund investors, lack of adequate disclosure of conflicts of interest, and certain conflicts of interest which are contrary to the public interest and cannot be managed" given what the SEC characterizes as a "lack [of] governance mechanisms " in private fund structures.<sup>6</sup> The SEC notes that these practices negatively impact investors' returns on their investment and often elevate the interest of advisers over those of investors. The Release states that "[w]ithout sufficiently clear, comparable information, even sophisticated investors would be unable to protect their interests or make sound investment decisions."<sup>7</sup>

At the open meeting, Commissioner Peirce voted against the proposal, noting that it "represents a sea change" and "embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds."<sup>8</sup>

If adopted, the proposed rules and amendments would significantly expand the SEC's oversight of private fund advisers and could have significant compliance and economic effects on these advisers, whether or not they are registered or required to be registered with the SEC, and private funds. The proposal would create substantive compliance and reporting requirements that are in certain respects more detailed and potentially more onerous than what is currently required from funds subject to registration under the Investment Company Act of 1940. The SEC's cost-benefit analysis provides a generalized discussion of costs, but does little to measure whether the benefits would outweigh these costs.<sup>9</sup>

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### OVERVIEW OF THE PRIVATE FUND PROPOSAL

The proposal would address practices by private fund advisers that the SEC believes have contributed to a lack of transparency and undisclosed conflicts of interest. The SEC also proposed corresponding amendments to the compliance and books and records rules to enhance its oversight of the proposed rules. In a number of respects, as discussed in more detail below, the proposed rules would seek to apply a one-size-fits-all model to the structure of the relationships between advisers and private fund investors, which are often highly negotiated between advisers and sophisticated institutional and other investors with the assistance of legal counsel and other advisors. The SEC's approach of imposing a number of blanket prohibitions and restrictions in this context appears to be in tension with its recent interpretation of the fiduciary duty under the Advisers Act—mentioned only briefly in the Release—which states that "[t]he fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."<sup>10</sup>

## Quarterly Statements

The proposal would require all investment advisers registered or required to be registered with the SEC to prepare and distribute to investors quarterly statements disclosing certain information about fees, expenses and performance for any private funds advised by such investment adviser within 45 days after the end of each calendar quarter, beginning after the fund's second full calendar quarter of generating operating results. The proposed rule would allow private fund advisers to consolidate reporting for substantially similar pools of assets if the adviser believes doing so provides more meaningful information to the private fund's investors. The SEC believes that the proposed rule would "help an investor better understand the relationship between the fees and expenses the investor bears and the performance the investor receives from the investment."<sup>11</sup> The quarterly statements would contain the following information:

- **Private Fund-Level Disclosures** in a table that includes, both before and after the application of any offsets, rebates or waivers, (i) a detailed accounting of all compensation, fees and other amounts allocated or paid to the investment adviser or any related persons by the fund,<sup>12</sup> with separate line items for each category of allocation or payment including, but not limited to, management, advisory, sub-advisory or similar fees or payments and performance-based compensation,<sup>13</sup> (ii) a detailed accounting of all fees and expenses paid by the private fund, with separate line items for each category of allocation or payment including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence and travel fees and expenses and (iii) the amounts of any offsets or rebates carried forward to subsequent periods;
- **Portfolio Investment-Level Disclosures** in a table that includes (i) a detailed accounting of all portfolio investment<sup>14</sup> compensation, including but not limited to origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments, allocated or paid, by the covered portfolio investment to the investment adviser or any of its related persons and attributable to the fund's interest in the portfolio investment, with separate line items for each category, allocation or payment, presented both before and after the application of any offsets, rebates or waivers and (ii) the fund's ownership percentage of each portfolio investment that paid or allocated portfolio investment compensation to the adviser or its related persons during the reporting period;
- **Calculations and Cross-References to Organizational and Offering Documents**, including (i) prominent disclosure of the method for calculating all expenses, payments, allocations, rebates, waivers and offsets and (ii) cross-references to the relevant sections of the private fund's organizational and offering documents that set forth the calculation methodology; and
- **Fund Performance**<sup>15</sup> disclosed using detailed and specific standardized metrics, applied on the basis of whether the fund is a "liquid fund"<sup>16</sup> or an "illiquid fund"<sup>17</sup> as defined in the proposed rule, with "liquid funds" disclosing performance based on net total return on an annual basis since the fund's inception, over prescribed time periods and on a quarterly basis for the current year,<sup>18</sup> and "illiquid funds" disclosing performance based on the fund's internal rate of return and a multiple of invested capital, on both a gross and net basis.<sup>19</sup>

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### **Mandatory Private Fund Audits**

In addition, the proposal would require private fund advisers registered or required to be registered with the SEC to obtain an audit of the financial statements for each private fund it manages at least annually and upon liquidation. The SEC believes that a requirement to conduct annual financial statement audits would help protect the fund and its investors from the adviser's loss, misappropriation or misuse of fund assets and serve as a check on the adviser's valuation of the fund's assets.

The proposed audit rule is based on the SEC's custody rule,<sup>20</sup> and includes many similar or identical requirements.<sup>21</sup> The audit would be required to be performed in accordance with generally accepted auditing standards of the United States by an independent public accountant that meets the independence standards in Regulation S-X and is registered with the Public Company Accounting Oversight Board. The proposed rule also generally would require audited financial statements to be prepared in accordance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP"). In the case of private funds organized outside of the United States, such audited financial statements would be required to include information substantially similar to those statements prepared in accordance with U.S. GAAP with reconciliation of any material differences from U.S. GAAP. The audited financial statements would be required to be distributed to investors promptly after the audit is completed.<sup>22</sup> If a private fund adviser does not have the requisite control over a fund to cause it to undergo an audit in a manner that satisfies all elements of the proposed rule, the adviser still would need to take all reasonable steps to cause the fund to obtain audited financials in compliance with the rule.

In addition, the proposed rule would mandate that an adviser's contract with the independent public accountant require the accountant to notify the SEC promptly upon issuing an audit report that contains a modified opinion and within four business days of the termination of the relationship or upon being removed from consideration for being reappointed.

### **Adviser-Led Secondaries**

In light of the increasingly active secondary market for private fund interests and the potential conflicts of interest that may arise from private fund advisers leading such transactions, the SEC is also proposing to require SEC-registered fund advisers to obtain a fairness opinion in connection with certain adviser-led secondary transactions and distribute such opinion to investors before closing the transaction. The proposed rule defines "adviser-led transactions" as "transactions initiated by the investment adviser or any of its related persons that offer the private fund's investors the choice to: (i) sell all or a portion of their interests in the private fund; or (ii) convert or exchange 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."<sup>23</sup> This definition would cover transactions where the adviser initiates, or causes others to initiate, the sale or exchange process and include so-called "continuation funds" which have become more prevalent in recent years. The SEC acknowledges that the specific facts and circumstances would determine whether a secondary transaction

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is adviser-led and clarified that a transaction initiated at the unsolicited request of an investor would not fall under this proposed rule.<sup>24</sup>

The proposed rule would require the fairness opinion to be given by an independent opinion provider that provides such opinions in the ordinary course of its business and that is not a related person of the adviser. The adviser would also be required to disclose any material business relationships it or any related person has or has had over the past two years with the opinion provider.

The SEC seeks comment on a number of questions that advisers and fairness opinion providers should consider carefully, including whether the opinion should be limited to price (or all terms of the transaction) and whether the opinion should state that the private fund and/or its investors may rely on the opinion.

### Prohibited Activities

The proposed rule would also prohibit certain sales practices, conflicts of interest and compensation schemes by the private fund adviser or its related persons that the SEC believes could result in fraud and investor harm. The proposed rule would prohibit the private fund advisers, including those that are not registered or required to be registered with the SEC, from, directly or indirectly, engaging in certain activities, and whether or not fully disclosed and regardless of any specific investor consent. The SEC does not provide a detailed explanation of how the proposed rule would interact with its fiduciary duty interpretation, which contemplates that in certain circumstances conflicts of interest may be averted through full and fair disclosures.<sup>25</sup> The proposed prohibitions include:

- **Charging Portfolio Investment Fees for Unperformed Services**, including monitoring, servicing, consulting or other fees for services that the adviser does not or does not reasonably expect to provide to the portfolio investment. The rule would not prohibit the adviser from receiving fees for services actually rendered or where there is 100% offset for such fees, as long as such offset can be applied;
- **Charging a Private Fund for Certain Fees and Expenses Related to Regulatory and Compliance Matters**, including (i) those associated with an examination or investigation of the adviser or its related person by any governmental or regulatory authority and (ii) regulatory and compliance fees of the adviser. The proposed rule would still allow private fund advisers to charge investors for regulatory, compliance and other similar fees and expenses directly attributable to the activities of the fund (such as costs associated with fund-level regulatory filings) but could have a significant impact on advisers that use an expense pass through model (although the Release contemplates an exemption for these advisers);<sup>26</sup>
- **Reducing Adviser Clawbacks for Taxes**, including actual, potential or hypothetical taxes applicable to the adviser, its related persons or their respective owners or interest holders. This prohibition would impact a commercial term that is market standard in the private fund industry, requiring advisers and investors to restructure their economic arrangements on this term;<sup>27</sup>
- **Limiting or Eliminating Liability for Adviser Misconduct**, including seeking reimbursement, indemnification, exculpation or a limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful malfeasance, bad faith, negligence or recklessness in providing services to the private fund. Although fund

documents typically do not permit an adviser or its related persons to seek indemnification or exculpation in the case of *gross* negligence, the prohibition applied to *ordinary* negligence, if adopted, would fundamentally change the liability structure for most private fund advisers. The Private Fund Release asks whether applying this prohibition to “gross negligence” would be more appropriate;<sup>28</sup>

- **Charging or Allocating Fees and Expenses for a Portfolio Investment on a Non-Pro Rata Basis** in circumstances where multiple private funds and other clients advised by the adviser or its related persons have invested in the same portfolio investment. The rule explicitly prohibits any non-pro rata allocation of fees and expenses among investment vehicles, including the practice of allocating fees incurred by co-investment vehicles or other co-investors to the adviser’s main fund; and
- **Borrowing** money, securities or other fund assets or receiving a loan or an extension of credit from a private fund client. The proposed rule would not restrict the adviser from borrowing from third parties or lending to the fund.

### Preferential Treatment

The proposal would flatly prohibit certain categories of preferential treatment while permitting other forms of preferential treatment if and only if the adviser discloses such preferential terms to all prospective and current investors. These prohibitions and disclosure requirements would apply to all private fund advisers, regardless of whether they are registered or required to be registered with the SEC.

First, the proposed preferential treatment rule would prohibit all private fund advisers, regardless of whether they are registered with the SEC, from providing certain preferential terms related to redemption and information rights to certain investors in a fund or pooled vehicle if such terms would have a negative effect on other investors in the fund or substantially similar pools of assets.

Under the proposed rule, advisers would no longer be allowed to grant an investor in the private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets. In addition, the rule would prohibit an adviser and its related persons from providing an investor with preferential information about portfolio holdings or exposures of the private fund, or of a substantially similar pool of assets, if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets. This latter prohibition is intended to “neutralize the potential for private fund advisers to treat portfolio holdings information as a commodity to be used to gain or maintain favor with particular investors.”<sup>29</sup>

In addition, the proposed rule would prohibit certain other preferential terms unless the adviser provides written disclosures to prospective and current investors, out of a concern that “current sales practices do not provide all investors with sufficient detail regarding preferential terms granted to other investors.”<sup>30</sup> Examples of terms that would be covered by this part of the rule include granting certain excuse rights from participating in specific types of investments or lower management fees. The proposed rule would require

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advisers to either describe the preferential treatment in enough detail to convey its relevance or provide copies of investor side letters to all potential and current investors. To comply, advisers would need to deliver these disclosures before an investor makes an investment in the fund, and annually thereafter to all current investors. This aspect of the proposed rule would fundamentally alter the fundraising process for private fund advisers.

### **Amendments to the Advisers Act Compliance Rule and Books and Records Rule**

The SEC also proposed amendments to the Advisers Act compliance rule to require all SEC-registered advisers to provide written documentation of their annual review of compliance policies and procedures. Under current rules, advisers must annually review compliance policies and procedures, as well as whether such policies and procedures have been effectively implemented, in order to evaluate whether the adviser's compliance policies and procedures continue to work as designed and whether changes are needed to assure their continued effectiveness.<sup>31</sup> The SEC believes that requiring written documentation of the annual review will encourage advisers to renew their attention on the annual compliance review as well as aid the SEC staff's review of whether advisers are acting in accordance with the compliance rule.<sup>32</sup> The proposed rule does not enumerate specific elements that advisers must include in their written documentation of the annual review.

In addition, the SEC proposes amending the Advisers Act books and records rule to require advisers to retain records related to the proposed quarterly statements, audited financials, adviser-led secondaries and preferential treatment rules. In conjunction with these newly proposed rules, advisers would be required to maintain all statements, notices, fairness opinions and disclosures distributed to investors under the proposed rule, as well as relevant distribution lists. In addition, to aid SEC oversight of the quarterly statement rule, advisers would be required to retain all records evidencing the calculation methods for all expenses, fees, payments, allocations, rebates, offsets, waivers and performance metrics disclosed to investors under the proposed quarterly statement rule, as well as records supporting the adviser's determination of whether the fund is liquid or illiquid.

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## ENDNOTES

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- 1 The Commission is currently comprised of only four commissioners following the recent departure of Commissioner Roisman which was announced in December 2021. See Statement of Commissioner Elad L. Roisman (Dec. 20, 2021), *available at* <https://www.sec.gov/news/statement/roisman-20211220>.
- 2 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955 (Feb. 9, 2022) (the “Release”). See *also*, SEC Fact Sheet: Private Fund Proposed Reforms (Feb. 9, 2022), *available at* <https://www.sec.gov/files/ia-5955-fact-sheet.pdf>
- 3 The proposal would apply to private funds that would be investment companies, as defined in section 3 of the Investment Company Act, but for Section 3(c)(1) or 3(c)(7). Although the Release does request comments on whether the quarterly statement rule should apply to funds relying on other exemptions, such as 3(c)(5)(C), the proposal does not extend to those funds that rely on other exemptions or exclusions from the Investment Company Act. *Id.* at 22.
- 4 *Id.* at 16.
- 5 *Id.*
- 6 *Id.* at 13.
- 7 *Id.* at 9.
- 8 Commissioner Hester M. Peirce, Statement by Commissioner Peirce on Private Fund Advisers Proposal (Feb. 10, 2022), *available at* <https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922>.
- 9 The Release notes that compliance costs associated with the proposed rule would include the costs of complying with the regulatory requirements, refraining from certain activities and obtaining the required external audits and fairness opinions. For some advisers, if adopted, the proposed rule would also potentially result in declining revenues and compensation to fund personnel, as well as the potential loss of employees or investor capital. The SEC also notes that some of these costs could be passed on to investors depending on the economic terms of their investment. Release, at 9.
- 10 *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)] (the “Fiduciary Duty Interpretation”), at 9.
- 11 Release, at 18.
- 12 The SEC proposes that related persons include (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. *Id.* at 29.
- 13 As an alternative to the robust fee disclosure requirements, the SEC is considering prohibiting certain adviser compensation arrangements, such as the “2 and 20” model or compensation from portfolio companies. The SEC believes these changes could cause advisers to adopt more efficient private fund investing models. *Id.* at 271–72. If adopted, these alternative proposals could upend compensation structures across the industry.
- 14 The SEC proposes to define “portfolio companies” as “any entity or issuer in which the private fund has invested directly or indirectly.” *Id.* at 41–42. This broad definition would capture credit-related instruments as well as more bespoke assets such as music royalties and aircraft vessels. The SEC designed the definition to be evergreen and capture new and evolving investment structures.

## ENDNOTES (CONTINUED)

- 15 The SEC recognizes the “commonalities” between the proposed performance reporting elements of the proposal and the SEC’s Marketing Rule (see Investment Adviser Marketing, Investment Advisers Act Release No. 5653 (Dec. 22, 2021)), but notes that the two rules satisfy different policy goals, with the performance reporting elements designed to address the needs of current investors, who should be able to evaluate an investment alongside corresponding fee and expense information at timely, predictable intervals. *Id.* at 56.
- 16 The SEC proposes to define a liquid fund as “a private fund that is not an illiquid fund,” *Id.* at 333.
- 17 The proposal generally includes closed-end funds that do not offer periodic redemption options, other than in exceptional circumstances. The proposed quarterly statement rule defines “illiquid fund” as “a private fund that: (i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor’s request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments.” *Id.* at 332.
- 18 Under the proposed rules, liquid funds would be required to disclose: (i) annual net total returns for each calendar year since inception; (ii) average annual net total returns over the one-, five-, and ten- calendar year periods; and (iii) cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement. *Id.* at 337
- 19 Under the proposed rules, illiquid funds would be required to disclose: (i) gross IRR and gross MOIC for the illiquid fund; (ii) net internal rate of return (IRR) and net multiple of invested capital (MOIC) for the illiquid fund; (iii) 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; and (iv) statement of contributions and distributions for the illiquid fund. *Id.* at 337
- 20 Rule 206(4)-2 under the Advisers Act (the “custody rule”).
- 21 The largest difference between the proposed audit rule and the custody rule is that the audit is mandatory under the proposed audit rule. In addition, the custody rule does not require accountants to notify the SEC upon termination or the issuance of a modified opinion. Thus compliance with the custody rule will not automatically satisfy the requirements of the proposed audit rule. Release, at 101–102.
- 22 The SEC notes in the Release that it believes a 120-day time period is generally appropriate to allow for the auditing and timely distribution of the entity’s financial statements. *Id.* at 108.
- 23 *Id.* at 330.
- 24 *Id.* at 338–39:
- 25 See the Fiduciary Duty Interpretation, *supra* note 10.
- 26 Release, at 276. The SEC notes that it could consider (but did not specifically propose) an exemption for funds with a passthrough expense model from the prohibition on charging fees or expenses associated with certain examinations, investigations, and regulatory and compliance fees and expenses to avoid the costs of re-structuring certain fee arrangements.
- 27 The SEC proposes to define “adviser clawback” as “any obligation of the adviser, its related person or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund’s governing agreements.” *Id.* at 144.
- 28 The proposal identifies specific types of contractual provisions that are already invalid under the Advisers Act, which prohibits the waiver of an adviser’s compliance with its federal antifraud liability for breach of fiduciary duty or other provisions of the Advisers Act and rules thereunder. See Section 215(a) of the Advisers Act; the Fiduciary Duty Interpretation, *supra* note 10.
- 29 *Id.* at 167.

ENDNOTES (CONTINUED)

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<sup>30</sup> *Id.* at 168.

<sup>31</sup> See *Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act*, SEC Release No. 2107 (Feb. 5, 2003).

<sup>32</sup> The SEC also notes that attempts by advisers to shield from or delay production of non-privileged documents through claims of the attorney-client privilege, the work-product doctrine or other similar protections are “inconsistent with prompt production obligations and undermines Commission staff’s ability to conduct examinations.” Release, at 181.

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