SULLIVAN & CROMWELL LLP

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SEC Rewrites Rulebook for $26 Trillion Private Fund Industry

Final Rules Impose Substantial Disclosure Obligations and Restrictions on Private Fund Advisers for a Broad Range of Activities

SUMMARY

On August 23, 2023, the Securities and Exchange Commission (the "SEC") voted 3 to 2 (Commissioners Peirce and Uyeda dissenting) to adopt new rules and amendments under the Investment Advisers Act of 1940 (the "Advisers Act")[1] that impose burdensome new requirements on investment advisers to private funds (the "Final Rules").[2] The Final Rules represent a significant expansion of the SEC's regulation of private fund advisers and will considerably alter how private fund advisers and investors in private funds—typically institutional investors, pension plans and high-net-worth individuals—structure their relationships. This memorandum supplements the discussion in our publication dated August 24, 2023 and provides a more detailed summary and analysis of the Final Rules. On September 1, 2023, a petition to review the Final Rules was filed in the United States Court of Appeals for the Fifth Circuit.[3]

According to the SEC, the Final Rules are intended to protect investors in private funds by increasing their visibility into certain practices regarding fees, expenses and fund performance; increasing disclosure around potential conflicts of interest; establishing requirements to address certain practices that the SEC believes have the potential to harm investors; and prohibiting or restricting certain practices that the SEC believes are contrary to the public interest and the protection of investors.[4] Although certain problematic aspects of the proposal, which we summarized and discussed in our publication, dated February 16, 2022, have been abandoned or modified, the Final Rules impose significant proscriptive disclosure and other requirements on private fund advisers, including in some cases private fund advisers that are not required to be registered with the SEC.[5] Ultimately, the Final Rules will create substantive compliance and reporting requirements that are in certain respects more detailed and potentially more onerous than what are currently required from registered funds.[6]

KEY TAKEAWAYS

- ***Legal Challenge Will Likely Have Significant Implications on the Scope of the SEC's Authority to Regulate Private Fund Advisers:*** A coalition of six U.S. trade associations representing private fund advisers and other related market participants filed a petition for review alleging that the Final Rules are harmful to the industry and its investors, exceed the SEC's statutory authority, were adopted without compliance with the notice-and-comment requirements of the Administrative Procedure Act and are other otherwise arbitrary, capricious, an abuse of discretion and contrary to the law and the SEC's heightened obligation to consider its rules' effects on efficiency, competition and capital formation. In the adopting release to the Final Rules (the "Release"), likely in anticipation of this challenge, the SEC included a lengthy discussion of its authority to adopt the rules under sections 206(4) and 211(h) of the Advisers Act.[7] Notably, many of the SEC's existing rules applicable to private fund advisers rely on section 206(4), which have not been previously challenged, and the SEC's proposed Predictive Data Analytics rule (summarized in our publication dated August 17, 2023) relies on section 211(h).[8]
- ***Heightened Examination Risk:*** The Final Rules include many requirements that will arm the SEC staff to find examination deficiencies and provide enforcement referrals, such as the requirement that advisers cross-reference in quarterly disclosures to the relevant sections of the private fund's organizational and offering documents that set forth the expense calculation methodology. This will incentivize advisers to funnel compliance resources towards compliance minutia, which creates a risk of misallocation of compliance time and resources from true fund and investor risks.
- ***Restrictions on Exculpation and Indemnification:*** The SEC did not adopt the proposed prohibition on an adviser from seeking reimbursement, indemnification, exculpation or limitation of liability for the adviser's breach of its fiduciary duty, willful misfeasance, bad faith, negligence or recklessness. Instead, the SEC included language in the Release stating that advisers may not waive their Federal fiduciary duty or seek reimbursement for breaches of such duty even when such breach may result from conduct involving only ordinary negligence (*i.e.*, not gross).[9] How this interpretation will be enforced by the SEC remains to be seen. Notably, as this is an interpretive position, it is effective 60 days after publication in the Federal Register.
- ***Legacy Treatment:*** Although the SEC granted some "legacy" treatment for certain aspects of the restricted activities and preferential treatment rules, this grandfathering is quite limited in scope. Further, despite the substantial new obligations of the Final Rules for both new and existing funds, the SEC provided short compliance periods (generally 12 to 18 months).
- ***Restricted Activities and Preferential Treatment Rules:*** Although the SEC did not impose outright prohibitions on activities in most cases and provided some exceptions to the proposed preferential treatment prohibitions, these rules are likely to have a chilling effect on certain practices that are commonplace in fundraising activities for many types of private funds. The detailed and, in some cases, advance disclosure and consent requirements may interfere with timely fund launches and the rights historically negotiated by certain investors, such as sovereign wealth funds, pension plans and foundations.
- ***Limited Partner Advisory Committees ("LPACs"):*** The SEC questioned the independence, authority and accountability of these bodies to oversee and provide consent to conflicts, which is a feature of many private funds, in accordance with the funds' organizational documents that are agreed to by fund investors. The SEC asserted that these bodies do not have a fiduciary duty to the fund's investors and criticized them for being conflicted and potentially placing their interests ahead of the fund or its investors.[10] Given the SEC's unfavorable description of LPACs, the Release raises questions about the effectiveness of LPACs to provide consents on behalf of private funds, including to principal transactions, going forward.

OVERVIEW OF THE FINAL RULES

The Final Rules address practices by private fund advisers that the SEC believes have contributed to a lack of transparency, undisclosed conflicts of interest and lack of governance mechanisms. Despite many footnotes in the Release noting the numerous settled enforcement actions (highlighting the SEC's current ability to address any problematic practices), the SEC stated that it still found these Final Rules to be necessary or appropriate and in the public interest. The Final Rules are titled the "Quarterly Statement Rule," the "Private Fund Audit Rule," the "Adviser-led Secondaries Rule," the "Restricted Activities Rule" and the "Preferential Treatment Rule." The SEC also amended the Advisers Act's books and records rule (the "books and records rule")[11] to require private fund advisers to keep records related to the Final Rules and amended the Advisers Act's compliance rule (the "compliance rule")[12] to require all registered advisers to provide written documentation of their annual compliance review. Each of these new rules and amendments are discussed in further detail below.

The Final Rules modify some of the blanket prohibitions that were included in certain aspects of the proposal and revise a few obligations that were considered the most onerous. Still, as discussed in more detail below, the Final Rules were adopted largely as proposed applying a one-size-fits-all model to the structure of relationships between advisers and private fund investors. As recognized in the Release, these relationships are often highly negotiated between advisers and sophisticated institutional and other investors with the assistance of legal counsel and other advisors.[13] Not recognized in the Release is the diversity in private fund types, making this one-size-fits-all model a compliance challenge. As such, the Final Rules will have a considerable impact on the structure of the relationships between advisers and private fund investors and the competitiveness of the private fund marketplace. Further, the SEC did not adopt the proposed prohibition on an adviser seeking reimbursement, indemnification, exculpation or limitation of liability for the adviser's breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund. Instead, the SEC expressed the view that existing law and guidance with respect to the adviser's Federal fiduciary duty and the anti-fraud provisions of the Advisers Act already address this practice. However, as discussed further below, the Release leaves open the interpretive question as to under what circumstances clauses that provide exculpation and indemnification for the adviser except in the case of gross negligence or more serious misconduct, which are prevalent within the private fund industry, may constitute a breach of the Federal fiduciary duty. Finally, the SEC also did not adopt the prohibition on charging fees for unperformed services, stating that such practice is inconsistent with an adviser's Federal fiduciary duty.

Quarterly Statement Rule

The Quarterly Statement Rule requires all investment advisers registered or required to be registered with the SEC[14] to prepare and distribute to investors quarterly statements disclosing certain information about fees, expenses and performance for any private fund advised by such investment adviser (other than with

respect to securitized asset funds).[15] The adviser to a private fund (other than a fund of funds) is required to distribute the quarterly statements within 45 days after the end of the first three fiscal quarters of a fiscal year and 90 days after the end of each fiscal year.[16] The Final Rules require private fund advisers to consolidate reporting for similar pools of assets[17] to the extent doing so provides more meaningful information to the private fund's investors.[18] The basis of consolidation, and important assumptions associated with consolidation, should generally be disclosed.[19] 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,[20] 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;[21] (ii) a detailed accounting of all fees and expenses allocated to or 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 amount of any offsets or rebates carried forward to subsequent periods.[22] The Quarterly Statement Rule does not permit any exclusions for *de minimis* expenses, general grouping of smaller expenses into broad categories, or labeling expenses as miscellaneous;[23]
- **Portfolio Investment-Level Disclosures** in a table that includes a detailed accounting of all portfolio investment[24] 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 of allocation or payment, presented both before and after the application of any offsets, rebates or waivers;[25]
- **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;[26] and
- **Fund Performance** disclosed using detailed and specific standardized metrics, applied on the basis of whether the fund is a "liquid fund"[27] or an "illiquid fund"[28] as defined in the Final Rules, with "liquid funds" disclosing performance based on net total return on an annual basis over the past 10 fiscal years or since the fund's inception (whichever is shorter), over prescribed time periods and on a quarterly basis for the current fiscal year,[29] 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.[30] The quarterly statement must include the as-of date through which the performance information is current and prominent disclosure of the criteria used and assumptions made in calculating the performance.[31] The SEC did not provide guidance on whether partially realized investments should be categorized as realized or unrealized, leaving it to the advisers' discretion and requiring disclosure of methodology.[32]

Despite commenters' requests to align the standards, the required fund performance disclosures in the Quarterly Statement Rule are inconsistent with the Advisers Act's marketing rule (the "marketing rule")[33]—specifically, the gross-only internal rate of return and multiple of invested capital for the realized and unrealized portions of the portfolio for illiquid funds and the additions of one-, five- and 10-year lookback periods for liquid funds. In addition, elements of the Quarterly Statement Rule can trigger application of the

marketing rule, such as by the adviser's providing these reports to a current or prospective investor for solicitation purposes or by including additional information in the quarterly statement. The Quarterly Statement Rule is mandatory, and investors cannot waive the right to receive quarterly statements.[34]

Private Fund Audit Rule

The Private Fund Audit Rule requires private fund advisers registered or required to be registered with the SEC to cause each private fund they advise (other than with respect to securitized asset funds), directly or indirectly, to undergo a financial statement audit that meets the requirements of the Advisers Act's custody rule (the "custody rule"),[35] and to cause audited financial statements to be delivered if the private fund does not otherwise undergo such an audit.[36] It is important to note, however, that the SEC recently proposed amendments to the custody rule in its release on February 15, 2023 (the "Safeguarding Release")[37] (summarized in our publication dated March 31, 2023) and, on August 23, 2023, reopened the comment period on that proposal. Private fund advisers registered or required to be registered with the SEC will be subject to any revisions to the custody rule proposed in the Safeguarding Release, if adopted.

Under the Private Fund Audit Rule, the audit would be required to be performed by an independent public accountant that meets the independence standards in Regulation S-X and is registered with the Public Company Accounting Oversight Board.[38] The audited financial statements must be prepared in accordance with generally accepted accounting principles ("GAAP").[39] 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 Private Fund Audit Rule, the adviser still would need to take all reasonable steps to cause the private fund to undergo a financial statement audit that meets the requirements of the custody rule and to cause audited financials to be delivered if the private fund does not otherwise undergo such an audit.[40] The "surprise examination" element of the custody rule (*i.e.*, the examination of client funds and securities under custody by an independent public accountant without prior notice to the adviser) will not meet the requirements of the Private Fund Audit Rule.[41] The audited financial statements must be delivered within 120 days of the end of a fiscal year and promptly following liquidation of the fund.[42] If an investor is a limited partnership, limited liability company or other type of pooled vehicle that is related to the adviser, the adviser must look through the pool to send the audited financial statements to the underlying investors.[43] The SEC adopted the Private Fund Audit Rule because it believes that a requirement to conduct annual financial statement audits provides an important check on the adviser's valuation of fund assets and certain conflicts of interest between the adviser and the investors.[44]

In addition, the proposal would have mandated 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. This requirement is not included in the Private Fund Audit Rule, as the SEC recently proposed similar amendments to the Safeguarding Release and is still considering such an amendment in that rulemaking.

Adviser-Led Secondaries Rule

The Adviser-Led Secondaries Rule requires fund advisers registered or required to be registered with the SEC to obtain a fairness opinion[45] or, in a change from the proposal, a valuation opinion,[46] in connection with certain adviser-led secondary transactions and distribute such opinion to investors before closing the transaction (other than with respect to securitized asset funds).[47] The SEC believes that this rule will "provide an important check against an adviser's conflicts of interest in structuring and leading such a transaction from which it may stand to profit at the expense of private fund investors."[48]

The Final Rules define "adviser-led secondary transaction" as "any transaction initiated by the investment adviser or any of its related persons that offers a private fund's (other than a securitized asset fund) investors the choice between: (i) selling all or a portion of their interests in the private fund; and (ii) 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."[49] This definition generally covers transactions where the adviser initiates, or causes others to initiate, the sale or exchange process that is designed to offer private fund investors the option between obtaining liquidity and rolling all or a portion of their interests into the other vehicle.[50] The definition includes so-called "continuation funds" which have become more prevalent in recent years.[51] In a significant change from the proposal, the Release states that tender offers are generally excluded from the definition of adviser-led transactions "if an investor is not faced with the decision between (1) selling all or a portion of its interest and (2) converting or exchanging all or a portion of its interest."[52] The Release states that "[g]enerally, if an investor is allowed to retain its interest in the same fund with respect to the asset subject to the transaction on the same terms (*i.e.*, the investor is not required to either sell or convert/exchange), as many tender offers permit investors to do, then the transaction would not qualify as an adviser-led secondary transaction."[53] The SEC acknowledges that the specific facts and circumstances determine whether a secondary transaction is adviser-led and clarified that a transaction initiated at the unsolicited request of an investor generally will not fall under the Adviser-Led Secondaries Rule.[54]

The Adviser-Led Secondaries Rule requires the fairness opinion or valuation 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.[55] The adviser is required to prepare and distribute a written summary of any material business relationships it or any related person has, or has had within the past two-year period immediately prior to the issuance of the opinion, with the independent opinion provider.[56]

Restricted Activities Rule

The Restricted Activities Rule places restrictions on five types of activities with respect to all private fund advisers, whether required to be registered with the SEC or not (other than with respect to securitized asset funds).[57] The SEC believes that these activities could result in fraud and investor harm.[58] In a significant change from the proposal (which would have flatly prohibited private fund advisers from engaging in many specified activities), the Restricted Activities Rule includes certain disclosure- and, in some cases,

consent-based exceptions. These changes could be seen as a relief to some of the most onerous obligations in the proposal. Specifically:

- **Charging or Allocating to a Private Fund Certain Fees and Expenses Associated with Governmental or Regulatory Investigations** is prohibited, ***unless*** the adviser requests each investor of the private fund to consent to, and obtains written consent from at least a majority in interest of the private fund's investors (not the private fund's LPAC) that are not related persons of the adviser for, such charge or allocation.[59] However, regardless of disclosure or consent, advisers may not charge or allocate to a private fund fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Advisers Act (or rules thereunder).[60]
- **Charging or Allocating to a Private Fund Certain Fees and Expenses Related to Regulatory and Compliance Matters, or Associated with Examination, of the Adviser or Its Related Persons** is prohibited, ***unless*** the adviser distributes a written notice of any such fees or expenses (including the dollar amount) to the investors of such private fund client in writing within 45 days after the end of the fiscal quarter in which the charge occurs.[61]
- **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, is prohibited, ***unless*** the adviser distributes a written notice to the investors of such private fund client that sets forth the aggregate dollar amounts of the adviser clawback before and after any reduction for taxes within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.[62]
- **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 is prohibited, ***unless*** (i) the non-pro rata charge or allocation is fair and equitable under the circumstances and (ii) prior to charging or allocating such fees or expenses to a private fund client, the adviser distributes to each investor of the private fund a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances.[63] There is no exemption for co-investment vehicles participating in a transaction.[64]
- **Borrowing** money, securities or other fund assets or receiving a loan or an extension of credit from a private fund client is prohibited, ***unless*** the adviser (i) distributes to each investor a written description of the material terms of, and requests each investor to consent to, such borrowing, loan or extension of credit; and (ii) obtains written consent from at least a majority in interest of the private fund's investors (not the private fund's LPAC) that are not related persons of the adviser.[65] The Restricted Activities Rule does not restrict the adviser from borrowing from third parties or lending to the fund.

The SEC did not address in the Release whether negative consent would be permitted, but the requirement of a "written consent" likely implies affirmative consent by the investors.

Fiduciary Duty Interpretation

The SEC did not adopt the proposed prohibition on an adviser's seeking reimbursement, indemnification, exculpation or limitation of liability for the adviser's breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund ("indemnification prohibition"). Instead, the Release expresses the view that existing law and guidance with respect to the adviser's Federal fiduciary duty and the anti-fraud provisions of the Advisers Act provide sufficient means of deterring and remedying the types of problematic conduct at which the proposed indemnification prohibition was aimed.[66] The Release states that whether contractual terms that purport to limit an adviser's liability in an agreement

with an institutional client (*e.g.*, private fund) would violate the Advisers Act's antifraud provisions "will be determined based on the particular facts and circumstances."[67] The SEC provides in the Release a few examples of what it believes to violate the antifraud provisions of the Advisers Act:

- when there is a contract provision waiving ***any*** and ***all*** of the adviser's fiduciary duties; or
- there is a contract provision explicitly or generically waiving the adviser's Federal fiduciary duty,

in each case, if there is no language clarifying that the adviser is not waiving its Federal fiduciary duty or that the client retains certain non-waivable rights.[68] In making this point, the SEC cites a consent order in 2022, but the relevance of that citation is unclear because the waiver of liabilities in that case was in agreements with retail investors.[69] And the SEC has recognized (and reaffirms such belief in the Release) that "full and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."[70]

Further, in contrast to the proposed indemnification prohibition, which did not distinguish between the potentially varying duties to which an adviser might be subject under different governing laws, the discussion in the Release repeatedly indicates that it speaks to the Federal fiduciary duty. Specifically, the Release states that the SEC "continue[s] to not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable State law."[71] The SEC's interpretation in the Release lacks clarity on which, if anything, it is changing with respect to indemnification practices, including the question of whether there is any conduct that constitutes ordinary (*i.e.*, not gross) negligence that does not also constitute a breach of the Federal fiduciary duty, therefore resulting in a prohibition on advisers seeking exculpation or indemnification for such conduct. At the open meeting, Commissioner Peirce questioned the staff whether there was "any piece [in the Final Rules] that's not consistent with the 2019 statement on fiduciary duty?"[72] Director Birdthistle responded, "I don't believe so."[73] Given that the Release is not clear, the contours of the SEC's interpretation and how that interpretation might be applied prospectively in an examination or enforcement context remain to be seen. Nonetheless, savings clauses generally should be included in all organizational documents, offering documents and any other documents that provide exculpation or indemnification for the adviser.

Finally, the SEC stated it did not adopt the prohibition regarding advisers' charging investors portfolio investment fees for unperformed services because such a practice is already inconsistent with an adviser's fiduciary duty.[74]

Preferential Treatment Rule

The Preferential Treatment Rule generally prohibits all private fund advisers, whether required to be registered with the SEC or not (other than with respect to securitized asset funds), from providing

preferential treatment with respect to (i) redemption rights or (ii) portfolio holdings or exposure information if the adviser reasonably expects that such treatment would have a material, negative effect on other investors in the private fund or a similar pool of assets.[75] In a significant change from the proposal (which would have outright prohibited certain preferential treatments in redemption rights or information rights altogether if they have a material, negative effect on other investors), the Preferential Treatment Rule includes the following exceptions to the general prohibition of preferential treatment in redemption rights and information rights:

- with respect to the redemptions prohibition, the exception is available (i) if the redemption right is required by any law, rule, regulation or order of certain governmental authorities that is applicable to the investor, the private fund or any similar pool of assets; or (ii) if the adviser has offered the same redemption ability to all other existing investors and will continue to offer such redemption ability to all future investors in the private fund or any similar pool of assets;[76] and
- with respect to the information prohibition, the exception is available if the adviser offers such information to ***all*** other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time.[77]

The Preferential Treatment Rule also prohibits other preferential terms (regardless of whether the adviser reasonably expects such terms to have a material, negative effect on other investors) unless the adviser provides written disclosures (i) to prospective investors of any preferential treatment related to any material economic terms; and (ii) to current investors of all preferential treatment.[78] Limiting the advance written notice requirement to preferential treatment that relates to material economic terms is a change from the proposal, which required prospective disclosure of all investment terms.[79] The Preferential Treatment Rule still requires advisers to provide to current investors comprehensive disclosure of all preferential treatment provided by the adviser or its related persons.[80] To comply, advisers would need to deliver these disclosures to current investors: (i) for illiquid funds, as soon as reasonably practicable following the end of the private fund's fundraising period; and (ii) for liquid funds, as soon as reasonably practicable following the investor's investment in the private fund.[81] The Preferential Treatment Rule also requires annual written notice that provides specific information regarding any preferential treatment provided by the adviser to other investors in the same private fund since the last written notice.[82]

According to the Release, "material economic terms" are those terms that "a prospective investor would find most important and that would significantly impact its bargaining position," including, but not limited to, "the cost of investing, liquidity rights, fee breaks, and co-investment rights."[83] One example in the Release of other preferential treatment that requires post-investment and annual disclosure, but may not necessarily constitute "material economic terms," is "excuse rights" (*i.e.*, the right to refrain from funding or otherwise participating in a specific investment the private fund plans to make) provided by an adviser to certain private fund investors.[84] Although the Preferential Treatment Rule imposes obligations that are less onerous than those in the proposal, it is still likely to fundamentally alter the fundraising process for private fund advisers.[85]

Legacy Status

In a change from the proposal, the Final Rules provide "legacy" status to certain private funds for limited aspects of the Preferential Treatment Rule and the Restricted Activities Rule. Specifically, "legacy" status is provided for:

- the requirements in the Restricted Activities Rule that require investor consent (*i.e.*, the restrictions on an adviser from borrowing from a private fund and from charging for certain investigation fees and expenses (*i.e.*, Final Rules 211(h)(2)-1(a)(1), (a)(5)));[86] and
- prohibitions in the Preferential Treatment Rule that prohibit advisers from providing certain preferential redemption rights and information about portfolio holdings (*i.e.*, Final Rule 211(h)(2)-3(a)).[87]

In each case, contractual agreements governing a private fund that has commenced operations as of the compliance date, and that were entered into in writing prior to the compliance date, are provided "legacy" status only if the requirement would require the parties to amend such governing agreements. However, this "legacy" provision does not permit an adviser to charge fees or expenses related to an investigation resulting in a sanction for an Advisers Act violation.[88]

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

The Final Rules amend the Advisers Act books and records rule to require advisers who are registered or required to be registered to retain records related to the Quarterly Statement Rule, the Private Fund Audit Rule, the Adviser-Led Secondaries Rule, the Preferential Treatment Rule[89] and the Restricted Activities Rule.[90] Due to the modifications to the Restricted Activities Rule, the Final Rules now include recordkeeping provisions related to the disclosure- and consent-based exceptions. The purpose of the amendments is to enhance advisers' internal compliance efforts and "to facilitate the [SEC]'s enforcement and examination capabilities by improving [its] staff's ability to assess an adviser's compliance with the [F]inal [R]ule[s]."[91] In conjunction with these new requirements under the Final Rules, advisers are required to maintain all statements, notices and consents, fairness opinions or valuation opinions, disclosures and other documents distributed to investors under the new rules, as well as relevant lists of recipients and dates.[92] In addition, to aid SEC oversight of the Quarterly Statement Rule, advisers are 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 Quarterly Statement Rule, as well as records supporting the adviser's determination of whether the fund is liquid or illiquid.[93]

The Final Rules also amend the Advisers Act compliance rule to require all private fund advisers who are registered or required to be registered to provide written documentation of their annual review of compliance policies and procedures.[94] 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.[95] The SEC believes that requiring

written documentation of the annual review will focus advisers' 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.[96] The SEC acknowledges that advisers may choose to document their annual reviews in various ways and does not prescribe a specific format of the written documentation.[97]

Compliance Dates

The SEC adopted tiered compliance dates for the Final Rules. Private fund advisers subject to the Final Rules must be in compliance with the new rules or amendments as of the applicable compliance date:

- The effective date for the Final Rules is 60 days after publication in the Federal Register (the "Effective Date");[98]
- The compliance date for the Quarterly Statement Rule and the Private Fund Audit Rule (both applicable to private fund advisers that are registered or required to be registered with the SEC) is 18 months after the Effective Date;[99]
- The compliance date for the Adviser-Led Secondaries Rule (applicable to private fund advisers that are registered or required to be registered with the SEC), the Restricted Activities Rule (applicable to all private fund advisers) and the Preferential Treatment Rule (applicable to all private fund advisers) is:
  - For larger private fund advisers with $1.5 billion or more in private funds assets under management, 12 months after the Effective Date; and
  - For smaller private fund advisers with less than $1.5 billion in private funds assets under management, 18 months after the Effective Date;[100]
- The compliance date for the amendments to the Advisers Act compliance rule (applicable to all SEC-registered advisers) is 60 days after the Effective Date;[101]
- The compliance date for the amendments to the Advisers Act books and records rule (applicable to private fund advisers that are registered or required to be registered with the SEC) is the compliance date for the underlying rule for which the records are required; and
- The interpretation in the Release of the Federal fiduciary duty for indemnification and unperformed fees (applicable to all investment advisers) will be effective upon the Effective Date.

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ENDNOTES

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-6383 (Aug. 23, 2023), *available at* https://www.sec.gov/rules/2022/05/private-fund-advisers-documentation-registered-investment-adviser-compliance-reviews (the "Release"). *See also* SEC Fact Sheet: Private Fund Adviser Reforms: Final Rules (Aug. 23, 2023), *available at* https://www.sec.gov/files/ia-6383-factsheet.pdf.

[2] The Final Rules apply to private funds that would be investment companies, as defined in section 3 of the Investment Company Act of 1940 (the "Investment Company Act"), but for section 3(c)(1) or 3(c)(7) of the Investment Company Act. Release, at 7–8. However, in a change from the proposal, the Quarterly Statement Rule, Private Fund Audit Rule, Adviser-Led Secondaries Rule, Restricted Activities Rule, and Preferential Treatment Rule do not apply to investment advisers with respect to securitized asset funds they advise.

[3] *See* Petition for Review, *Nat'l Ass'n of Priv. Fund Managers* v. *Sec. and Exch. Comm'n*, No. 23-60471 (5th Cir., Sept. 1, 2023).

[4] Release, at 1.

[5] The Release states that "none of the final rules or amendments apply with respect to the offshore fund clients of an SEC-registered offshore adviser," which is a historical approach taken by the SEC on substantive rules of the Advisers Act. *Id.* at 48. In addition, as discussed further in this publication, the rules regarding restricted activities and preferential treatment apply to all private fund advisers, regardless of whether they are required to be registered with the SEC. The Release clarifies, however, that the rules regarding restricted activities and preferential treatment do not apply to offshore unregistered advisers with respect to their offshore funds (regardless of whether the funds have U.S. investors). *Id.* at 49.

[6] Commissioner Uyeda stated in his remarks that private fund advisers would be subject to six additional requirements compared to other SEC-registered investment advisers with respect to the private funds they manage: (1) private funds must have annual financial statement audits; (2) private funds must prepare and deliver quarterly statements; (3) private funds are prohibited from entering into specified arrangements with their advisers—including certain fee and expense allocation arrangements—unless they satisfy certain conditions; (4) adviser-led secondary transactions will be prohibited unless the adviser obtains and distributes a fairness or valuation opinion; (5) private fund advisers may not enter into tailored arrangements with private fund investors regarding redemption rights and portfolio holdings disclosures unless those same arrangements are offered to all other investors; and (6) private fund advisers may not enter into any other type of tailored arrangements with a private fund investor unless existing and prospective investors receive written notice. *See* Mark T. Uyeda, Statement on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Aug. 23, 2023), *available at* https://www.sec.gov/news/statement/uyeda-statement-private-fund-advisers-082323.

[7] *See* Release, at 28–45.

[8] *See* Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, SEC Release Nos. 34-97990; IA-6353 (Jul. 26, 2023), 88 FR 53960 (Aug. 9, 2023).

[9] Release, at 251.

[10] *See id.* at 19–20.

[11] Rule 204-2 under the Advisers Act, 17 C.F.R. § 275.204-2 (2022) (*Books and records to be maintained by investment advisers*).

[12] Rule 206(4)-7 under the Advisers Act, 17 C.F.R. § 275.206(4)-7 (*Compliance procedures and practices*).

[13] *See*, *e.g.*, Release, at 216, 240.

ENDNOTES (CONTINUED)

[14] The Quarterly Statement Rule also applies to registered U.S. sub-advisers to funds whose primary adviser is an exempt reporting adviser or an offshore registered investment adviser. Release, at 70, n.197.

[15] Final Rule 211(h)(1)-2 (to be codified at 17 C.F.R. § 275.211(h)(1)-2). The SEC believes that the Quarterly Statement Rule will increase transparency on fees and performance, which will, among other things, help address conflicts of interest concerns and help investors to better "interpret complex performance reporting and assess the relationship between the fees paid in connection with an investment and the return on that investment as they monitor their investment and consider potential investment." Release, at 23.

[16] In a change from the proposal (which would have required distribution of the quarterly statements within 45 days of the end of each "calendar quarter"), the Quarterly Statement Rule references the end of each fund's "fiscal quarter" and "fiscal year" and extends the timeline for the fiscal year-end statement to 90 days. Final Rule 211(h)(1)-2(a). In a further change from the proposal (which would have imposed the same timeline requirement with respect to funds of funds and non-funds of funds), the Quarterly Statement Rule provides additional time with respect to funds of funds (compared to non-funds of funds)—if the private fund is a fund of funds, a quarterly statement must be distributed within 75 days after the end of the first three fiscal quarters and 120 days after the end of the fiscal year of the private fund. *Id.* The change is in response to commenters that stated that many funds of funds will need to receive reporting from their private fund investments before they are able to prepare and distribute their own quarterly statements. Release, at 145.

[17] In a change from the proposal (which would have applied to "substantially similar pool of assets"), the Final Rules apply to "similar pool of assets" and defines the term 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, or a securitized asset fund) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons." Final Rule 211(h)(1)-1 (to be codified at 17 C.F.R. § 275.211(h)(1)-1). The Release states that the change in the defined term "better reflects the broad scope of the definition," and that "depending on the facts and circumstances, the definition will likely capture vehicles outside of what the private funds industry would typically view as 'substantially similar pools of assets.'" Release, at 286.

[18] Final Rule 211(h)(1)-2(f).

[19] Release, at 153, n.440.

[20] The Final Rules define "related persons" to 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. Final Rule 211(h)(1)-1. The Release notes that this is the same definition as used in Form ADV. Release, at 81, n.235.

[21] As indicated in the proposal, the SEC considered prohibiting certain adviser compensation arrangements, such as the "2 and 20" model or compensation from portfolio companies as an alternative to the robust fee disclosure requirements. However, the SEC concludes in the Release that "[t]here are benefits to flexible negotiations between advisers and investors," and that the Final Rules "should not endeavor to create a rigid private fund contract that governs all possible outcomes of an investment." *Id.* at 577–78.

[22] Final Rule 211(h)(1)-2(b).

[23] Release, at 80.

ENDNOTES (CONTINUED)

[24] The Final Rules define "portfolio investment" broadly to include "any entity or issuer in which the private fund has directly or indirectly invested." Final Rule 211(h)(1)-1.

[25] In a change from the proposal, the Final Rules did not adopt the requirement to also disclose 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. Release, at 101–02.

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

[27] The Final Rules define a liquid fund as "a private fund that is not an illiquid fund." Final Rule 211(h)(1)-1.

[28] In a change from the proposal (which would have used six factors to identify an illiquid fund), the Final Rules define "illiquid fund" as "a private fund that: (i) is not required to redeem interests upon an investor's request; and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund." Final Rule 211(h)(1)-1. The Release notes that "illiquid funds" generally include closed-end funds that do not offer periodic redemption/renewal options, other than in exceptional circumstances (such as in response to regulatory events). Release, at 114.

[29] Under the Quarterly Statement Rule, liquid funds are required to disclose: (i) annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever time period is shorter; (ii) average annual net total returns over the one-, five- and 10-fiscal-year periods; and (iii) cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement. Final Rule 211(h)(1)-2(e)(2)(i).

[30] Final Rule 211(h)(1)-2(e). In a change from the proposal (which would have required disclosure of performance figures solely *without* the impact of fund-level subscription facilities), under the Quarterly Statement Rule, the performance measures of illiquid funds are to be computed *with and without* the impact of any fund-level subscription facilities. Illiquid funds are required to disclose: (i) gross internal rate of return and gross multiple of invested capital for the illiquid fund; (ii) net internal rate of return and net gross multiple of invested capital for the illiquid fund; (iii) gross internal rate of return and gross multiple of invested capital 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. Final Rule 211(h)(1)-2(e)(2)(ii)(A).

[31] Final Rule 211(h)(1)-2(e)(2)(iii).

[32] Release, at 139–40.

[33] Rule 206(4)-1 under the Advisers Act, 17 C.F.R. § 275.206(4)-1 (2022) (*Investment adviser marketing*). In the Release, the SEC recognizes the commonalities between the proposed performance reporting elements of the proposal and the marketing rule, 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. Release, at 107.

[34] Release, at 72.

[35] Rule 206(4)-2 under the Advisers Act, 17 C.F.R. § 275.206(4)-2 (2022) (*Custody of funds or securities of clients by investment advisers*).

[36] Final Rule 206(4)-10 (to be codified at 17 C.F.R. § 275.206(4)-10). In a change from the proposal, the final Private Fund Audit Rule directly cross-references the custody rule.

[37] Safeguarding Advisory Client Assets, SEC Release No. IA-6240 (Feb. 15, 2023), 88 FR 14672 (Mar. 9, 2023).

[38] Final Rule 206(4)-10(a).

ENDNOTES (CONTINUED)

[39] The Release notes that "[t]he SEC has stated that certain financial statements must either be prepared in accordance with U.S. GAAP or prepared in accordance with some other comprehensive body of accounting standards if the information is substantially similar to financial statements prepared in accordance with U.S. GAAP and contain a footnote reconciling any material differences." *Id.* at 164, n.470 (citing Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2176 (Sept. 25, 2003), 68 FR 56691 (Oct. 1, 2023), at n.41; Staff Responses to Questions about the Custody Rule, *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm).

[40] Final Rule 206(4)-10(b).

[41] Rule 206(4)-2(a)(4) under the Advisers Act, 17 C.F.R. § 275.206(4)-2(a)(4) (2022) (*Custody of funds or securities of clients by investment advisers—Safekeeping required—Independent verification*). The Release expressly acknowledged that the Private Fund Audit Rule "would effectively eliminate the surprise examination option under the custody rule for private fund advisers and may increase costs to some investors." Release, at 166.

[42] Rule 206(4)-2(b)(4) under the Advisers Act, 17 C.F.R. § 275.206(4)-2(b)(4) (2022) (*Custody of funds or securities of clients by investment advisers—Exceptions—Limited partnerships subject to annual audit*).

[43] Rule 206(4)-2(c) under the Advisers Act, 17 C.F.R. § 275.206(4)-2(c) (2022) (*Custody of funds or securities of clients by investment advisers—Delivery to Related Persons*).

[44] Release, at 161.

[45] "Fairness opinion" is defined to mean "a written opinion stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair." Final Rule 211(h)(1)-1.

[46] "Valuation opinion" to mean "written opinion stating the value (as a single amount or a range) of any assets being sold as part of an adviser-led secondary transaction." Final Rule 211(h)(1)-1.

[47] Final Rule 211(h)(2)-2.

[48] Release, at 187.

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

[50] Release, at 191–92.

[51] *See id.* at 188–89.

[52] *Id.* at 194–95.

[53] *Id.* at 195.

[54] *Id.* at 192.

[55] Final Rule 211(h)(1)-1.

[56] Final Rule 211(h)(2)-2(a)(2).

[57] Final Rule 211(h)(2)-1.

[58] Release, at 206.

[59] The SEC states that it considered, but did not adopt, an exemption for funds with a pass-through expense model from this restriction, as advisers will be able to obtain consents from investors of such funds to apply such charge or allocation. *Id.* at 242. The Commission also noted that given that the Commission "may already require advisers to pass-through funds to pay penalties associated with a sanction under the [Advisers] Act, [the SEC] anticipate[s] that this rule will not cause a significant disruption from current practice for advisers to pass-through funds." *Id.* n.720.

ENDNOTES (CONTINUED)

60 Final Rule 211(h)(2)-1(a)(1).

61 Final Rule 211(h)(2)-1(a)(2).

62 Final Rule 211(h)(2)-1(a)(3). The Final Rules define "adviser clawback" as "any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements." Final Rule 211(h)(1)-1.

63 Final Rule 211(h)(2)-1(a)(4).

64 Release, at 235–36.

65 Final Rule 211(h)(2)-1(a)(5).

66 *Id.* at 256. For example, the Release notes that "[a] waiver of an adviser's compliance with its Federal antifraud liability for breach of its fiduciary duty to the private fund or otherwise, or of any other provision of the Advisers Act, or rules thereunder, is invalid under the [Advisers] Act." *Id.* at 258.

67 *Id.* at 259.

68 *Id.* at 260–61.

69 *See In the Matter of Comprehensive Capital Management, Inc.*, SEC Release No. IA-5943 (Jan. 11, 2022).

70 Release, at 259; *see also* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248 (June 5, 2019), 84 FR 33669 (July 12, 2019).

71 Release, at 261.

72 Transcript of U.S. Securities and Exchange Commission Open Meeting, Bloomberg Gov't (Aug. 23, 2023) (statement of Hester M. Peirce).

73 *Id.* (statement of William Birdthistle).

74 Release, at 251.

75 Final Rule 211(h)(2)-3(a). The SEC stated that it intends the standard of "material, negative effect" to "remain evergreen so that it can be applied to various types of arrangements between advisers and investors and fund structures." Release, at 273.

76 Final Rule 211(h)(2)-3(a)(1).

77 Final Rule 211(h)(2)-3(a)(2).

78 Final Rule 211(h)(2)-3(b).

79 Final Rule 211(h)(2)-3(b)(1).

80 Final Rule 211(h)(2)-3(b)(2); Release, at 263.

81 In a change from the proposal, the Final Rule requires after-the-fact notice for preferential treatment terms that are not material economic terms and sets a different timeline for liquid funds and illiquid funds. Final Rule 211(h)(2)-3(b)(2).

82 Final Rule 211(h)(2)-3(b)(2)(iii).

83 *Id.* at 294.

84 *Id.* at 295.

85 The Release suggests that disclosure could take the form of, for example, copies of side letters (with identifying information regarding other investors redacted) or a written summary of the preferential terms provided to other investors. *Id.* at 297.

ENDNOTES (CONTINUED)

[86] Final Rule 211(h)(2)-1(b).

[87] Final Rule 211(h)(2)-3(d).

[88] *Id.*

[89] The language of the amended books and records rule related to the Preferential Treatment Rule was adopted as proposed, despite the change from the proposal to include exceptions to the prohibition of preferential treatment regarding redemption rights and information on holdings. Final Rule 204-2(a)(7)(v).

[90] Final Rule 204-2(a).

[91] Release, at 28.

[92] In a change from the proposal, the Final Rule did not adopt the requirement that advisers also make and retain records of the addresses or delivery methods used to disseminate any documents. Final Rule 204-2(a).

[93] Final Rule 204-2(a)(20)(ii), (22).

[94] Final Rule 206(4)-7(b).

[95] *See Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act*, SEC Release No. IA-2107 (Feb. 5, 2003), 86 FR 7038 (Feb. 11, 2003).

[96] Release, at 27, 302. The SEC also states that attempts by advisers to "improperly shield from, or unnecessarily delay production of any non-privileged record is inconsistent with prompt production obligations and undermines [SEC] staff's ability to conduct examinations." *Id.* at 308.

[97] *Id.* at 307.

[98] *Id.* at 2.

[99] *Id.* at 308.

[100] *Id.*

[101] *Id.*

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