CLEARY GOTTLIEB

ALERT MEMORANDUM

Fund Rules Dampened, Not Defanged:

SEC's final private fund rules drop proposed bans on certain activities, but still have bite.

August 31, 2023

On August 23, 2023, the U.S. Securities and Exchange Commission ("**SEC**") adopted new rules under the Investment Advisers Act of 1940 (the "**Advisers Act**") that will significantly impact private fund advisers (the "**Final Rules**"). Although the Final Rules abandoned most of the headline prohibitions in the SEC's original proposal (the "**Proposed Rules**") from February 10, 2022 (discussed in our Alert Memo here) — which created shock waves through the industry for its proscriptive requirements and tone — the Final Rules still contain onerous and market practice-changing requirements. The Final Rules do **not** prohibit indemnification for negligence or ban the standard practice of accounting for taxes in clawback requirements, as the Proposed Rules threatened. But they do impose substantial new and detailed quarterly reporting requirements, two prohibitions and many new disclosure requirements for side letters and expense allocations, and restrict certain other activities, which the SEC explicitly warned that Exam and Enforcement Staff will be closely reviewing. With a few limited exceptions, all registered advisers ("**RIAs**") will have their hands full implementing new and modified reporting, and RIAs, exempt reporting advisers ("**ERAs**") and other advisers exempt from registration must develop processes — and make difficult judgments — about providing preferential treatment to selected investors and engaging in the targeted activities.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

WASHINGTON

Robin M. Bergen
+1 202 974 1514
rbergen@cgsh.com

Amber V. Phillips
+1 202 974 1548
avphillips@cgsh.com

Lyric Gupta
+1 202 974 1788
lgupta@cgsh.com

NEW YORK

Maurice R. Gindi
+1 212 225 2826
mgindi@cgsh.com

Emily Alfano
+1 212 225 2626
ealfano@cgsh.com

Lauren P. Heller
+1 212 225 2908
lheller@cgsh.com

We summarize below some high-level observations and notable points from the Final Rules (available here) along with specific interpretive issues that the industry needs to consider during the transition period. A chart summarizing each new rule is attached at the end of this alert.

clearygottlieb.com

© Cleary Gottlieb Steen & Hamilton LLP, 2022. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

High-Level Observations

— *Indemnification Uncertainty*: In an important win, the SEC dropped the prohibition on limitations of liability and indemnification for simple negligence. The SEC makes clear, though, that advisers still cannot waive their Federal fiduciary duties or seek reimbursement for breaches of such duties, and that a breach of fiduciary duties may arise from conduct that is merely negligent. So-called "hedge clauses" were last addressed in the SEC Staff's 2019 Fiduciary Duty Guidance (discussed here), which expressed skepticism that hedge clauses are consistent with the antifraud provisions. It appears the SEC may be planting seeds to expand that position, by stating that indemnification for conduct (such as negligence) that could be a fiduciary duty breach is effectively a waiver that is invalid under the Advisers Act. How this new position will manifest remains to be seen given the widespread practice of adviser indemnification.

—*Preferential Treatment Prohibitions and Restrictions a Mixed Bag for Investors*: The disclosure requirements for side letter provisions were adopted largely as proposed, with partially relaxed delivery timing. Preferential redemption rights are prohibited if the adviser reasonably expects them to have a "material, negative effect" on other investors, with narrow exceptions for redemption rights required by law or offered to all investors (e.g., share classes with different liquidity terms so long as all investors have the ability to elect). Redemption rights linked to avoiding undesirable legal, regulatory or tax impacts are not carved out, which may sting regulated or tax sensitive investors such as banks, pension funds and charitable foundations. Preferential information about portfolio holdings or exposure is also prohibited if the adviser reasonably expects such sharing to have a material, negative effect on other investors. While the SEC hopes the Final Rules will "help investors better understand marketplace dynamics and potentially improve efficiency for future investments," the prohibitions and restrictions on preferential treatment, and the new legal standards that advisers must parse in order to apply them, may have a chilling effect that prevents investors from obtaining rights they have long viewed as essential.

—*Reporting Required for Legacy Funds*. While the Final Rules grant limited legacy treatment for certain restricted activities and preferential treatment provisions —to avoid mandating amendments to existing fund documents — most requirements will apply to both existing and new funds. Advisers have only 18 months to implement quarterly reporting and annual audits for all existing fund clients. Despite the adopting release for the Final Rules (the "**Adopting Release**") clocking in at an impressive 660 pages, a number of interpretive questions remain about the scope and content of the reports.

—*The Proposed Rules Housed Some Red Herrings as We Hoped*. Some of the most alarming aspects of the Proposed Rules came in the proposing release and requests for comment, with even more severe prohibitions than the formal Proposed Rules put on the table such as a ban on 2 and 20 compensation or caps on management fees. Fortunately, the Final Rules went the other way and removed virtually all proposed bans without adding others. However, it was far from a complete victory for the industry. The detailed and rigid requirements will present real challenges for advisers, and exam deficiencies, enforcement referrals and investigations will have the feel of fish in a barrel.

—*The SEC is Preparing to Litigate*. Likely in response to the extensive body of comment letters, many from prominent industry groups, challenging the SEC's authority for the Proposed Rules, the SEC explained, at length, why the Final Rules are "a proper exercise of [the SEC's] rulemaking authority under [Sections 206(4) and 211(h) of] the Advisers Act to prevent fraudulent, deceptive, and manipulative conduct, facilitate the provision of simple and clear disclosures to investors, and prohibit or restrict certain sales practices, conflicts of interest, and compensation schemes." The Adopting Release introduction spent over fifteen pages on this defense, and each section provided more analysis. The SEC plainly took the risk of litigation seriously, and changes in the Final Rules big and small seem aimed at diffusing legal challenges.

—*Continued Cynicism of Fund Governance*. The Final Rules repeat the proposal's critiques of limited partner advisory committees ("**LPACs**") as conflicted bodies that may place their own interests ahead of the fund or the investors as a whole. The SEC identifies

the "lack of governance mechanisms" at private funds as a primary factor contributing to investor protection harms. The Final Rules dismissed all comments urging that disclosures, consents or other requirements be satisfied through LPACs, and even applied the preferential information rights provisions to information received by LPACs. While it is still unclear what the SEC's end-game is for LPACs, the Final Rules require consent of a majority of limited partners for certain restricted activities, not the LPAC, regardless of the fund's contractual provisions governing consent, which has long been the Advisers Act standard.

— *SAFs are Safe (For Now)*. In a welcome change for the CLO industry, the SEC acknowledged that securitized asset funds, or "**SAFs**," such as CLOs, are not subject to the transparency and other investor protection concerns that animate the Final Rules, and as a result SAFs are excluded from all requirements. SAFs are defined as "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders," and picks up most asset-backed securitizations. The definition of "private fund" remains limited to 3(c)(1) and 3(c)(7) exempt funds under the Investment Company Act of 1940; the SEC declined to extend the definition to 3(c)(5) real estate funds and other exempt vehicles.

— *ERAs and Offshore Advisers have Reason to Celebrate*. Longstanding principals regarding the application of substantive compliance requirements have prevailed, with exempt advisers only subject to the limitations on preferential treatment and restricted activities, and offshore advisers receiving blanket relief from the rules with respect to their non-U.S. funds. However this relief does not clearly extend to the U.S. RIA affiliates of offshore advisers who act as sub-advisors to those non-U.S. funds, teeing up difficult interpretive questions regarding whether such U.S. advisers will either need to produce quarterly reports and audited financial statements for these previously exempt non-U.S. funds or otherwise significantly modify their sub-advisory roles.

The Quarterly Statement Rule

New rule 211(h)(1)-2 (the "**Quarterly Statement Rule**") requires RIAs to send investors a quarterly statement for every private fund client with granular itemized reporting of compensation, fees, expenses and performance. Statements must be delivered within 45 days after the end of the fund's first, second and third fiscal quarters and within 90 days after the fund's fiscal year end. The Final Rules add time for funds of funds – 75 days after each of the first three fiscal quarters and 120 days after fiscal year end, though given the requirements this is likely to be insufficient for many. Notably though, the Adopting Release states that there would be no basis for an enforcement action if an RIA cannot timely deliver the statement due to reasonably unforeseeable circumstances, as long as the RIA reasonably believed the statement would be distributed on time and the RIA delivers it as promptly as practicable. We expect that Enforcement investigations will focus on these standards and so RIAs should analyze and retain documentation to support their actions when there is a delay. The SEC acknowledged that some quarter-end numbers may not be available by the delivery deadline, in which case advisers are required to include performance calculations through "the most recent practicable date," which would generally be through the end of the immediately preceding quarter.

As proposed, the Quarterly Statement Rule requires RIAs to consolidate reporting for similar pools of assets (discussed further below) to the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading. Given that the definition of "similar pool" overlaps with (and is broader than, as discussed below) "related portfolios" in the Marketing Rule, this should, at a minimum, include the same vehicles that RIAs consolidate for purposes of performance advertising.

The Adopting Release indicates that an RIA can use a data room for distribution if it notifies investors within the required period that the statements have been uploaded and ensures that investors have access. This reporting is in addition to the quarterly reports

provided by qualified custodians under the Custody Rule and the annual financial statements provided under the Custody Rule or the new Audit Rule (discussed below). Given the different delivery periods, it may be difficult for RIAs to manage. For example, year-end quarterly reports must be delivered one month before audited financials are distributed and two months before they are distributed for a fund of funds.[1]

The Adopting Release states that investors may not waive their right to receive quarterly statements. While the SEC recognizes that fund reporting can be highly negotiated, the Quarterly Statement Rule is intended to serve as a "baseline" to allow investors to more easily compare funds and advisers, as well as focus their negotiation priorities on other matters. While that may be true, quarterly reporting is also a fund expense that is typically borne by the investors and it remains to be seen whether the extra cost will be welcome for some of the required reporting items.

Compensation, Fee and Expense Disclosure. As proposed, quarterly statements must include a detailed table with fund-level information (broken out in line item categories) of (i) all compensation, fees and expenses allocated or paid to the RIA or its related persons, including compensation for consulting, legal or back-office services, (ii) all fees and expenses otherwise allocated to or paid by the private fund (including broken deal expenses) and (iii) the amount of any offsets, rebates or waivers carried forward. All of these items must be shown both before and after the application of any offsets, rebates, or waivers. The Rule prohibits the exclusion of *de minimis* expenses, the grouping of smaller expenses into broad categories, or labeling items as miscellaneous. The level of detail required here goes far beyond typical industry practice and will require significant work to prepare systems to be able to report.

RIAs also must provide a separate detailed table for all portfolio investment compensation, fees and expenses allocated or paid by each "covered portfolio investment" to the RIA or its related persons during the reporting period (including fees for origination, management, consulting, monitoring, servicing and administration and directors' compensation). The table must specify both cash and non-cash compensation (such as stock, options and warrants) and present amounts both before and after the application of any offsets, rebates, or waivers. The Final Rules dropped the proposed disclosure of the private fund's ownership percentage of each covered portfolio investment. However, disclosed amounts must reflect only the private fund's portion of the full amounts, and cannot reflect any portion attributable to any other person's interest in the covered portfolio investment (such as a co-investor or, presumably, a debt investor). The non-fund portions may be separately disclosed at the RIA's election.

"**Covered portfolio investments**" are those that paid the RIA or its related persons compensation during the reporting period. Compensation for this purpose is defined broadly, and means any compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons including, but not limited to, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments. A "**portfolio investment**" is any entity or issuer in which the private fund has invested directly or indirectly. In addition to equity interests, this definition captures any entity or issuer in which the private fund holds an interest, including debt instruments and indirect interests through holding companies, subsidiaries, acquisition vehicles and

[1] While not defined in the Final Rules, longstanding guidance under the Advisers Act's Custody Rule defines a fund of funds as a private fund that invests 10% or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser. This guidance sets a significantly lower bar than Form PF, which requires a private fund to invest "substantially all" of its assets in the equity of private funds for which the filer is not the adviser in order to be a disregarded fund of funds, and it remains to be seen what definition will be applied by the SEC Staff. *See* Staff Responses to Questions About the Custody Rule, https://www.sec.gov/divisions/investment/custody_faq_030510.

special purpose vehicles. As a result, the definition may capture more than one entity or issuer with respect to any single investment made by a private fund. Covered portfolio investments do **not** include the counterparties to derivatives transactions, due to the SEC's belief that any gain or loss in these investments is tied to the performance of the derivative and not the counterparty. Dividends are not included in the portfolio investment compensation disclosure requirements The Final Rules do not require RIAs to list any information regarding portfolio investments beyond those in the covered portfolio investment definition.

The Final Rules did not add the exception for funds of funds (which are one step removed from a covered portfolio investment) that commenters requested. The SEC cited the fund of funds RIA's ability to request the information needed to determine whether an entity making the payment is a portfolio investment of the fund of funds. However, the SEC did recognize that fund of funds RIAs may rely on a good faith belief to determine which entities constitute covered portfolio investments. Coupled with the related person definition discussed below, this will be very challenging for institutional asset managers with multiple lines of businesses that hold indirect interests.

The SEC also rejected concerns about confidentiality issues if RIAs are required to disclose the names of portfolio investments, stating that investors are already likely to know the names of a fund's portfolio investments and are subject to contractual confidentiality obligations. However, the Final Rules allow RIAs to use consistent code names when the identity of a covered portfolio investment is not necessary to understand the disclosure.

The definition of "**related person**" for purposes of compensation, fee and expense disclosure tracks the Form ADV definition, and covers (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. "**Control**" for this purpose also applies the Form ADV definition, and covers actual control as well as presumed control where there is a 25% voting or economic interest (depending on entity type). All related persons are in scope for disclosure, including sub-advisers (who receive management fee compensation) and entities that are not influenced by the RIA, such as those who negotiated their services with the fund or portfolio investment on arm's length, third party terms. The Adopting Release suggests that compensation received by employees of an adviser's affiliate will also be subject to disclosure. Where an adviser or affiliate holds an interest in another private fund that rises to the level of "control" under existing Advisers Act guidance, that fund will also constitute a "related person." However, funds that an adviser merely manages, without any additional interest, have historically not been considered related persons.

Performance Disclosures. Consistent with the proposal, the Final Rules require RIAs to include standardized and specific fund performance information in each quarterly statement, with different metrics required for "illiquid funds" versus "liquid funds." The definition of "**illiquid fund**" was streamlined to focus on redemption rights, dropping the Proposed Rules' imprecise references to a fund's term, ongoing capital raising efforts and operating strategy. Instead, an illiquid fund is defined as a private fund that: (1) is not required to redeem interests upon an investor's request; and (2) has limited opportunities, if any, for investors to withdraw before the fund's termination. This alleviates some ambiguity for hybrid funds, although there is still room for interpretation as to what constitutes a "limited opportunity" to redeem and the Adopting Release did not provide guidance. For example a fund may offer redemption rights every five years, which may or may not constitute a "limited opportunity." A "**liquid fund**" is defined as any private fund that is not an illiquid fund.

Consistent with the Proposed Rules, RIAs to "liquid funds" must show (1) annual net returns since inception or the last ten fiscal years, whichever is

shorter; (2) average annual net total return over a one-, five- and ten-fiscal year period; and (3) cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.

Also consistent with the Proposed Rules, RIAs to "illiquid funds" must show (1) gross and net internal rate of return ("**IRR**") and multiple of invested capital ("**MOIC**") for the full fund since inception; (2) separate gross IRR and gross MOIC (but not net) for the realized and unrealized portions of the portfolio; and a statement of contributions and distributions for the fund, including (a) all capital inflows and outflows to investors since inception and (b) the net asset value of the fund as of the end of the reporting period. The Adopting Release makes clear that IRR must be calculated to the day and not, for example, by using a mid-month convention. Unlike a liquid fund, there is no option to present only a ten year performance look-back, presumably because the typical life of an illiquid fund is limited. Notably, the SEC did not provide guidance on determining which portions of the portfolio are realized and unrealized (for example, in the case of recapitalizations). Instead, RIAs must make the decision in their discretion and disclose and document their methodology. This is interesting in light of the SEC Staff's recent focus in examinations on this characterization issue. Distributions recalled by RIAs for additional investments, known as recycling, must be treated as additional contributions for purposes of these performance metrics.

In a change from the proposal, the Final Rules require the performance metrics be included both with and without the impact of any fund-level subscription facilities. Interestingly, while the Adopting Release states that "levered" performance figures, when presented alone, have the potential to mislead investors (a point RIAs should keep in mind when presenting those figures in marketing materials), fund-level subscription facilities are described as an "important cash management tool." The Adopting Release does not include any exception for short-term liquidity facilities. It does, however, carve out fund-level guarantees of portfolio investment indebtedness, noting that even though investors' unfunded commitments may indirectly support the fund's guarantee, those guarantees generally are not put in place to enable the fund to delay calling investor capital. Most sponsors do not currently produce both levered and unlevered performance figures, and creating two sets of performance metrics is likely to be onerous and require some assumptions (required to be disclosed).

It is not clear how the Quarterly Statement Rule expects RIAs to factor certain taxes into the IRRs. Typically private fund advisers do not show returns that reflect investor-specific taxes (including withholding taxes, or certain taxes associated with blockers or other bespoke investment structures that have been requested by tax sensitive investors but which are implemented by the fund) and it likely is not feasible to require this level of disclosure, given the array of investor-specific tax attributes. Thankfully, the Adopting Release discusses accounting for deemed cash flows, and these taxes are usually treated as deemed distributions. Unless the SEC Staff provides guidance, RIAs should explicitly disclose where tax and other investor-specific expenses have and have not been deducted.

Methodology Disclosure and Cross-references to Fund Documents. Each quarterly statement must include prominent disclosure regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated (e.g., whether such compensation is fixed, based on performance over a certain period, or based on the value of the fund's assets, the distribution waterfall, etc.), and include cross references to the relevant sections of the fund's organizational and offering documents with the calculation methodology. While this is purportedly to facilitate "an investor's ability to seek additional information," realistically the cross-references will better serve as a tool for examinations and investigations by SEC Staff, and we expect market practice for cross-references to develop with an eye squarely on defending those provisions. In light of this risk, advisers will undoubtedly spend significant time

and dollars on these disclosures, likely to be borne by investors.

Quarterly statements must include the "as of" date for the performance information and prominent disclosure of the criteria used and assumptions made in calculating the performance. RIAs generally should also disclose the basis of any consolidated reporting in the quarterly statement (such as consolidation of structuring vehicles or other similar pools), including which entities are captured and the methods used to calculate the amounts on the statement from each entity.

Overlap with the Marketing Rule and Other Obligations. The required elements of the Quarterly Statement Rule will not constitute "advertisements" under the Marketing Rule, but any information not strictly required — including where demanded by investors — may be subject to the Marketing Rule. Similarly, the moment a quarterly statement is provided to one prospective investor, or used in discussions with existing investors as part of a solicitation, the Marketing Rule will attach. The antifraud rules and the SEC Staff's Fiduciary Duty Guidance will also apply regardless of whether the quarterly statement is considered an "advertisement" under the Marketing Rule. RIAs should therefore carefully compare the disclosure in quarterly statements with similar disclosure in fund documents and offering materials to ensure a consistent approach and generally apply the same process used for advertisements.

As in the Proposed Rules, the final Quarterly Statement Rule remains inconsistent with the presentation of performance under the Marketing Rule despite numerous comments. The proscribed gross-only calculation methods for IRR and MOIC of the realized and unrealized portions of the portfolio and the addition of a one-, five-, and ten- year period lookback for liquid fund performance are both inconsistent with the Marketing Rule, which generally requires net performance for all metrics and excludes private funds from lookback. Notably, the SEC reiterated the position in the proposal that "calculating net figures for the realized and unrealized portions of the portfolio could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees, expenses, and adviser compensation between the realized and unrealized portions….such assumptions have the potential to erase the benefits that net performance measures would provide."

Scope and Grandfathering. As proposed, the Quarterly Statement Rule only applies to RIAs and their private funds clients, and not ERAs. It does not apply to SAFs. The Adopting Release also confirms that the Quarterly Statement Rule will **not** apply to the non-U.S. fund clients of offshore RIAs regardless of whether they have U.S. investors. The SEC, however, explicitly declined to exempt registered U.S. sub-advisers with respect to a private fund whose primary adviser is an ERA or an offshore RIA (or otherwise not subject to the Rule) or limit the scope to U.Ss private fund clients, even for affiliated sub-advisers. Perversely then, offshore advisers who have chosen to register their U.S. operations instead of operate them as a branch office must produce quarterly statements for offshore clients advised by the U.S. teams. Moreover, because the offshore advisers are generally related persons of the U.S. RIAs, compensation paid to the offshore advisers are captured by the Final Rules' reporting requirements.

The Quarterly Statement Rule has no grandfathering, and reports must be provided for all new and existing funds after the applicable compliance date. New funds must begin reporting after their second full fiscal quarter. Given that most existing funds require some form of quarterly reporting previously negotiated with investors, RIAs will be faced with the tough choice of either renegotiating those terms or producing additional reports. Legacy funds are also unlikely to have budgeted for the significant costs of preparing these reports, which may create real issues for them.

The Restricted Activities Rule

Perhaps the most significant relaxation in the Final Rules from the Proposed Rules is the treatment of certain restricted (previously prohibited) activities by advisers in new rule 211(h)(2)-1 (the "**Restricted Activities Rule**"). The Final Rules drop the flat

prohibition on certain activities, in favor of two categories of restricted activities: those requiring prior written consent from investors (government investigation costs and borrowing from private fund clients) and those requiring either advance or after-the-fact disclosure (compliance and examination fees and expenses, after-tax clawbacks, and non-*pro rata* fee or expense allocations).

Consent requires that the adviser obtain prior written consent from at least a majority in interest of investors in the relevant fund who are not related persons of the adviser (except in the case where all investors are related persons, such as employee vehicles). The Adopting Release states that a fund's governing documents may generally prescribe the manner and process by which consent is obtained and notes as an example excluding from a vote non-voting interests and defaulting investors. The Adopting Release does not address other aspects of voting mechanics in a fund's governing agreement that have become industry standard, such as using negative consent or otherwise disregarding non-responsive investors. However, in our experience, requirements for "written consent" often are interpreted to mean affirmative consent. The SEC also stated that consent must be provided by investors rather than other fund governance bodies, such as an LPAC, given the lack of fiduciary obligations by those bodies to investors. This prohibition on LPAC consent is a concrete manifestation of the SEC's rhetoric against LPACs as a conflicted and inadequate fund governance mechanism in both the Proposed Rules and the Adopting Release, and is hopefully not an indication that LPAC consent for conflicted transactions (and other consents required under the Advisers Act) will be subject to future restriction by the SEC. Advisers should review and enhance their conflict and other disclosures about LPACs and other consent bodies with the Adopting Release in mind, as we expect examinations and investigations will focus on this issue.

Disclosure to investors generally requires detailed and specific written notice of the anticipated activity or charge. After-the-fact disclosure is permitted for charging compliance and examination costs and after-tax clawbacks, but disclosure must be provided in advance with respect to non-*pro rata* allocations of investment fees or expenses.

Investigation Costs. The Final Rules prohibit advisers from charging or allocating to a private fund fees or expenses of an investigation of the adviser or its related persons by any governmental or regulatory authority unless the adviser obtains written consent from a majority of unrelated investors. This will presumably include local, state and Federal investigations, as well as investigations by non-U.S. agencies. It is unclear whether informal inquiries from regulators will also be covered. The Adopting Release notes that advisers should provide disclosure of the specific fees and expenses actually expected to be charged regarding "each specific investigation," including by listing each category of fee or expense as a separate line item, and describing its relation to the investigation. This suggests that blanket upfront consents (for example, in connection with an investor's subscription to the fund) will not be sufficient because an adviser likely cannot provide the required details in advance of those fees and expenses being incurred. Investors will rarely have an incentive to consent to bearing this expense if it is not part of pre-agreed upfront negotiations, so this is in many ways a back door prohibition.

The Final Rules maintain only one flat prohibition on activities: advisers cannot charge fees or expenses related to an investigation resulting in a court or governmental authority imposing a sanction for violating the Advisers Act or rules promulgated thereunder. If any fees or expenses were consented to, and paid, by investors during the life of the investigation, they must be refunded by the adviser if the investigation concludes with an impermissible sanction.

Borrowing. The Final Rules prohibit advisers from directly or indirectly (including through a related person) borrowing money, securities or other fund assets, or receiving a loan or an extension of credit, from a private fund client, unless the adviser (1) distributes notice to each investor of the material terms

of the borrowing, loan or extension of credit and (2) obtains written consent from at least a majority of unrelated investors.

As with investigation-related expenses, while advisers are permitted under the Final Rules to borrow from private fund clients, we expect borrowing activity to become more limited as consent is effectively required on a case-by-case basis. Seeking blanket upfront consent will be difficult for the same reason as for investigation costs, namely that the material terms of the relevant borrowing (which the SEC suggests could include amount, interest rate and repayment schedule) are unlikely to be known in advance. While seeking specific consent for certain conflicted transactions is a common practice, generally an adviser would seek LPAC consent rather than running a broad (and time consuming) affirmative consent process across all investors in a fund.

The Adopting Release clarifies that the Final Rules do **not** prohibit ordinary course tax advances (aside from those that would require an adviser to repay the fund, rather than simply reduce the adviser's future income) and management fee offsets. To the extent borrowings are used in connection with carried interest structures, they are also subject to the Final Rules. It is unclear how broadly the SEC Staff will interpret "extensions of credit" under the Final Rules.

The Final Rules do not prevent the adviser from borrowing from a third party on the fund's behalf or from lending to the fund.

Compliance and Examination Costs. The Final Rules prohibit advisers from charging or allocating to a private fund any regulatory and compliance fees and expenses, or examination-related costs, of the adviser or its related persons unless the adviser distributes written notice of such fees and expenses, and the amount, to investors in the private fund within 45 days after the end of the fiscal quarter in which the charge occurred. The Adopting Release notes that the written notice should include a detailed accounting of each category of fees and expenses, and each specific category of fee or expense should be listed as separate line items with dollar amounts. Such disclosure may be included in the fund's quarterly reporting. For new funds, sponsors should think carefully about what costs will be passed on to investors and include adequate disclosure in the fund marketing materials (expenses could include the cost of quarterly reports, fairness and valuation opinions for adviser-led secondary transactions and other costs associated with the Final Rules). It is unclear how expenses associated with complying with certain aspects of the Final Rules themselves will be captured by this.

Reducing Adviser Clawback for Taxes. The Final Rules permit an adviser to reduce the amount of any performance allocation clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders, if the adviser distributes written notice to the investors of the applicable fund with the aggregate dollar amounts of both the before- and after-tax amount of the clawback within 45 days of the end of the fiscal quarter in which the clawback occurs.

This reflects another significant relaxation from the Proposed Rules, which would have prohibited these clawbacks and required advisers to renegotiate contractual terms with potentially devastating financial impact on advisers who relied on the benefit of their bargained for agreement. We expect compliance with this requirement to be straightforward.

Non-pro Rata Fee or Expense Allocation. The Final Rules prohibit advisers from charging or allocating fees or expenses related to a portfolio investment (or potential portfolio investment) on a non-*pro rata* basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment, including broken deal expenses, unless (1) the non-*pro rata* charge or allocation is fair and equitable under the circumstances and (2) **prior** to such charge or allocation, the adviser distributes written notice to each investor of the non-*pro rata* charge or allocation and a description of how it is fair and equitable under the circumstances. Whether a non-pro charge or allocation is fair and equitable will depend on factors relevant for the specific expense. Advisers may struggle to comply with this requirement for complex

structures where non-*pro rata* allocations abound, such as costs associated with the creation of blocker vehicles in a parallel fund structure. Non-*pro rata* allocations of expenses among investors within a single fund are presumably not picked up by the Restricted Activities Rule but would need to be separately analyzed under the Preferential Treatment Rule.

The SEC declined to define *pro rata* but acknowledged that advisers often tie a *pro rata* allocation to ownership of the relevant portfolio investment. Advisers will need to establish and document their approach.

Disclosure is required before a fund is charged or allocated fees on a non-*pro rata* basis, which the SEC believes is appropriate to allow investors to discuss non-*pro rata* allocations with the adviser before they are charged. However, requiring advanced disclosure could significantly limit flexibility with respect to closing transactions, and may ultimately have the effect of advisers foregoing non-*pro rata* allocations of expenses in order to ensure a timely closing. This could have the perverse outcome of expenses being borne between clients in a manner that may not be the most equitable (even if they are *pro-rata*) given the applicable circumstances. Furthermore, there is no carve-out for non-*pro rata* allocations where co-investment vehicles are participating in a deal, which could have the effect of chilling co-investment (or pushing co-investors to make their commitments post-closing) and potentially causing funds to pass on larger transactions or bear warehousing risk.

The Adopting Release notes that if a fund does not have the resources to pay its share of expenses on a *pro rata* basis, the adviser is not prohibited from diluting that fund's interest in the investment in a manner that is fair and equitable, and consistent with both law and the fund's governing documents.

Concessions in the Final Rules. In response to extensive industry comments (and more than a few threats of litigation), the SEC chose not to adopt two prohibitions from the Proposed Rules.

Limitation of Liability and Indemnification**.** In an important win for advisers, the SEC dropped the proposed prohibition on limitations of liability and indemnification for simple negligence. Notably, the SEC was not swayed by comments detailing the economic hardship this prohibition would have on advisers. Instead, the Adopting Release states that the prohibition was not needed to begin with, as "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." So-called "hedge clauses" were last addressed in the SEC's 2019 Fiduciary Duty Guidance, which stated that there are few (if any) circumstances where a hedge clause with a retail investor would be consistent with the antifraud provisions, whereas for an institutional client it will depend on the facts and circumstances. The Adopting Release also notes that to the extent that a hedge clause creates a conflict of interest between an adviser and its client, the adviser must address the conflict as required by its duty of loyalty. An adviser could be forgiven for reading the Adopting Release's statements and being unclear about what, if any, changes are required to their fund documentation governing indemnification and duty of care. The SEC notes that in the view of SEC Staff, an adviser violates the antifraud provisions of the Advisers Act, when (1) there is a contract provision waiving any and all of the adviser's fiduciary duties or (2) 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 (also known as a "**savings clause**"). The SEC also notes that "a breach of the Federal fiduciary duty may involve conduct that is intentional, reckless, or negligent" and "we believe 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 Act." What does this all mean? Most clearly, savings clauses should be included in fund

governance documents, management agreements, offering documents and anywhere else an adviser discusses or disclaims its fiduciary duty. In our experience, Examination Staff have been increasingly focused on both the inclusion of savings clauses and the expansiveness of the language in offering documents as well as LPAs and management agreements. It remains a bit of an open question as to whether the Staff is trying to preserve the argument that, since the securities laws may still impose liability on an adviser for conduct that constitutes simple negligence, seeking an indemnification for that liability would be an invalid waiver under the Advisers Act — which would be a significant position for them to take.

Fees for Unperformed Services. The SEC dropped the Proposed Rules' prohibition on an adviser charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide. However, the SEC warned advisers that the activity would violate their fiduciary duty in any event. The Adopting Release states that an explicit prohibition was not necessary because such activity would already be "inconsistent with the adviser's fiduciary duty." The Adopting Release also cited numerous enforcement actions against advisers based on the view that, "as a fiduciary," an adviser "may not keep prepaid advisory fees for services that it does not, or does not reasonably expect to, provide to a client." The SEC notes that advisers may not do indirectly what they could not do directly, and that charging fees for unperformed services to a portfolio investment is equivalent to indirectly charging those fees to the fund. Finally, lest it was unclear, the Adopting Release warns that SEC Staff will issue exam deficiencies for fees being charged for unperformed services and, depending on the facts and circumstances, this conduct may also violate other Federal securities law, rules and regulations.

The Adopting Release refers to any unperformed services and casts a wide net to capture any discrepancies between fees charged and services performed, not just payments under acceleration clauses. This will capture upfront transaction fees and regular monitoring fees from both a substantive and documentation perspective. Retainers will be more difficult if the tie to actual performance completed over time cannot be shown. Compliance teams should prepare to defend the validity of an adviser's service fees against breach of fiduciary duty claims, particularly where terminations of service agreements are not accompanied by a refund or true-up.

Scope and Grandfathering. As proposed, the Restricted Activities Rule will apply to RIAs and ERAs. The Adopting Release clarifies that the Restricted Activities Rule does **not** apply to offshore advisers with respect to their non-U.S. fund clients, regardless of whether the funds have U.S. investors. It will not apply to SAFs. Limited grandfathering is available for restricted activities that require investor consent (i.e., investigation costs and borrowing from a private fund client), but only if compliance with the Final Rules would require an amendment to existing documents.

The Preferential Treatment Rule

New rule 211(h)(2)-3 (the "**Preferential Treatment Rule**") softens the sting of some of the Proposed Rules but will still create challenges for advisers (both RIAs and ERAs) in determining how to make necessary disclosures for legacy funds and manage investor expectations for new funds. While the SEC hopes the Final Rules will "help investors better understand marketplace dynamics and potentially improve efficiency for future investments," the prohibitions and restrictions on preferential treatment, and the new legal standards that advisers must parse in order to apply them, may have a chilling effect that prevents investors from obtaining rights they have long viewed as essential.

Prohibited Preferential Redemptions. The Preferential Treatment Rule prohibits advisers from, directly or indirectly (including through a related person), granting an investor in a private fund 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 similar pool of

assets, with two exceptions: (1) if the ability to redeem is **required** by the applicable laws, rules, regulations, or orders of any relevant foreign or U.S. Government, State, or political subdivision to which the investor, the private fund, or any similar pool of assets is subject and (2) 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 and any similar pool of assets (e.g., share classes with different liquidity terms are permissible so long as all investors have the ability to subscribe. On the other hand, share classes with different liquidity terms offered to all investors based on size are not permitted, but share classes are permitted to exchange fees for liquidity). The exception for redemption rights required by applicable law is a welcome change from the Proposed Rules, but narrower than the industry hoped and reasonably expected. Many developments could result in materially adverse tax or regulatory consequences for a particular investor, or otherwise be contrary to government policy, without being outright prohibited by law. These concerns are not covered by the exception. Indeed, the Adopting Release notes that this exception is intended to be "narrowly tailored to limit potential harms to other investors to those cases that are absolutely necessary" and cannot be applied to informal arrangements such as compliance with an investor's policies and procedures. While advisers may avoid the prohibitions by determining that the relevant redemption right will not have a material, negative effect on other investors, it is unclear this case could be made if a redemption would require a realization of assets or other tangible economic impact in order to cash out the redeeming investor.

Prohibited Preferential Information. The Preferential Treatment Rule also prohibits advisers and their related persons from providing information about the portfolio holdings or exposures of the private fund **or** a similar pool of assets to any investor 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 similar pool of assets, with one exception: if the adviser offers such information to all other existing investors in the private fund **and** any similar pool of assets at the same or substantially the same time. The Rule is broad and picks up **all** types of communication: "formal and informal, as well as written, visual and oral." In a positive development, the Adopting Release states that the SEC "would generally not view preferential information rights provided to one or more investors in an illiquid private fund as having a material, negative effect on other investors" due to the general inability to redeem, although this determination is facts and circumstances dependent, and the SEC declined to provide a blanket exception for closed-ended funds. The SEC's example of information sharing that would cause a material, negative effect sets a very low bar. The Adopting Release states that where an adviser agrees to waive a confidentiality obligation in a private fund's governing agreement for one investor, such waiver can harm other investors because third parties may receive proprietary or confidential information that negatively impacts the fund's competitive advantage when making investments.

Similar Pools. Prohibited preferential treatment relates not only the investors in a particular fund, but also investors in any "**similar pool of assets**" (defined as a pooled investment vehicle other than a registered investment company or a SAF with substantially similar investment policies, objectives, **or** strategies to those of the private fund). "Similar pools of assets" may include funds of one, parallel funds, alternative investment vehicles and any other pooled investment vehicles depending on their investment policies, objectives and strategies, which will be a facts and circumstances determination. Notably, proprietary accounts of the adviser or its related persons might also be considered similar pools of assets. "Similar pools of assets" is defined more broadly than "related portfolios" under the Marketing Rule, where an entity required substantially similar investment policies, objectives, **and** strategies. A similar pool under this rule requires only one of the three. Advisers will be hard pressed therefore to exclude from the Preferential Treatment Rule any entity they include in performance information as a related portfolio. The SEC states that

the broad definition is intended to prevent advisers from structuring around the prohibitions. For example, in a master-feeder structure, some advisers create custom feeder funds for select investors. The SEC states that the Final Rules preclude advisers from providing preferential treatment to investors in these custom feeder funds to the detriment of investors in standard commingled feeder funds within the master-feeder structure.

Preferential treatment with respect to redemption and information rights is generally provided as an investor accommodation, and advisers will be solely on the hook to exercise their own legal judgment in deciding whether the preferential treatment can be reasonably expected to have a material, negative effect on other investors. While the Adopting Release provides that an adviser's actions will be judged based on the facts and circumstances at the time the adviser grants or provides the preferential treatment, hindsight is 20/20, and it remains to be seen how conscientiously the SEC adheres to this standard. Enforcement cases, as well as exams and risk alerts are likely to follow when the SEC, after the fact, asserts this standard has not been met.

Disclosure of Preferential Treatment. All permissible preferential treatment requires specific and extensive disclosure to investors: (1) **before** a prospective investor's investment in a private fund, written disclosure regarding preferential treatment **related to any "material economic terms"** that the adviser or its related persons are providing to other investors in the same fund and (2) **post-closing** written disclosure of **all** preferential treatment the adviser or its related persons has provided to other investors in the same fund to current investors "as soon as reasonably practicable" following (a) the end of the private fund's fundraising period for illiquid funds, (b) the investor's investment in the private fund for liquid funds, and thereafter, and (c) **annual** written information about any preferential treatment provided by the adviser or its related persons to other investors in the same fund since the last written notice. Notably, the Preferential Treatment Rule requires advisers to disclose the actual preferential terms, such as actual different fee rates — simply disclosing the existence of different terms will not satisfy the Rule. However, information identifying the preferentially treated investor is not required and information may be provided in a range. As with the mandatory placement agent disclosures under the Marketing Rule, we expect there to be extensive industry debate over the level of specificity required in these disclosures.

Preferential treatment captures terms provided by either the adviser or its related persons (acting on their own behalf and/or on behalf of the fund), both in formal side letters and informal communications such as email. Unlike the prohibited treatment discussed above, the general disclosure provisions do not apply to preferential treatment (1) granted to investors in a similar pool or (2) that would have a material negative effect on investors in a similar pool. However, such preferential treatment may be relevant where an investor invests in **both** a fund and a similar pool as the negotiations in one pool may be influenced by preferential rights received in the other.

"**Material economic terms**" is not defined in the Rule, but the Adopting Release states that it includes, but is not limited to, "the cost of investing, liquidity rights, fee breaks, and co-investment rights." Similarly, "**as soon as reasonably practicable**" is not defined in the Rule, and the Adopting Release states that this will depend on the facts and circumstances, although "it would generally be appropriate for advisers to distribute the notices within four weeks." While the Final Rules softened these disclosure requirements, they will still pose logistical challenges. In addition to the ambiguity regarding what is a material economic term, advisers of illiquid funds will also generally need to begin the disclosure process to ensure that investors receive information about rights granted to other investors within a month of final close or, for advisers of liquid funds, within a month of each closing. The processes will also need to include detailed disclosure of all terms, not just those the investor is able to elect.

The Preferential Treatment Rule could also require disclosure of information that may not be picked up by traditional MFNs, like multi-fund "frequent flyer"

discounts that are often bespoke and highly negotiated. It is unclear whether terms granted to feeder funds, which are treated as "investors" in the fund and not as advisory clients of the adviser, will be covered by the disclosure requirement. This ongoing reporting requirement will create another fact heavy disclosure document that compliance personnel must ensure is entirely consistent with underlying side letter contractual provisions and Form ADV disclosures, making it another tool for examinations and investigations focused on whether, in hindsight, disclosures have captured the appropriate level of detail.

Scope and Grandfathering. Consistent with the Proposed Rules, the Preferential Treatment Rule will apply to RIAs and ERAs. The Adopting Release clarifies that it does **not** apply to offshore advisers with respect to their non-U.S. fund clients, regardless of whether the funds have U.S. investors. The Rule will not apply to SAFs, nor are SAFs considered to be similar pools. U.S. sub-advisors are not carved out of compliance with the Rule, and so have disclosure obligations even where the primary adviser to the fund is not subject to the Rule (as, for example, an ERA or an offshore RIA).

Limited grandfathering is available for preferential redemption and information rights under the Preferential Treatment Rule if a private fund has commenced operations as of the compliance date and the rights were put in writing prior to the compliance date, but only if compliance with the Final Rules would require an amendment to existing documents.

"**Commencement of operations**" includes investment, fundraising, or other operational activity, meaning that the Final Rules cannot be circumvented by merely signing operating documents earlier than or on the compliance date. Governing agreements include but are not limited to LPAs and similar constitutional documents, subscription agreements and side letters. Commencement of operations will include any bona fide activity directed towards operating a private fund, including investment, fundraising or operational activity. The SEC notes as specific examples issuing capital calls, establishing a subscription facility, holding an initial closing, diligencing potential investments or making an investment.

The SEC declined to extend grandfathering to the disclosure portion of the Preferential Treatment Rule. As a result, these disclosure requirements apply after the compliance date, and will include disclosure of side letters agreed to prior to that date. The SEC notes that as a practical matter, a private fund that does not admit new investors or provide new terms to existing investors does not need to deliver an annual notice. However, an adviser that enters into a side letter after the closing date of the fund must disclose any preferential terms in the side letter to existing investors.

The Adviser-Led Secondaries Rule

New rule 211(h)(2)-2 (the "**Adviser-Led Secondaries Rule**") requires RIAs to obtain a fairness opinion or a valuation opinion from an independent opinion provider in connection with adviser-led secondary transactions. The Rule was adopted largely as proposed, except it now also allows a "valuation opinion" instead of a fairness opinion. A "**valuation opinion**" is a written opinion stating the value (either as a single amount or a range) of any assets being sold as part of an adviser-led secondary transaction. By contrast, a "**fairness opinion**" addresses the fairness from a financial point of view to a party paying or receiving consideration in a transaction. An "**independent opinion provider**" provides fairness or valuation opinions in the ordinary course of its business and is not a related person of the RIA. The RIA must also distribute to investors a written summary of any material business relationships the adviser or any of its related persons has, or has had in the prior two years, with the independent opinion provider. Whether a business relationship is material requires a facts and circumstances analysis; however, the Adopting Release notes that audit, consulting, capital raising, investment banking, and other similar services would typically meet this standard. Both the opinion and written summary must be distributed prior to the due date of the election form for the transaction.

An "**adviser-led secondary transaction**" is any transaction initiated by the RIA that offers fund investors the option 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 for new interests in another vehicle advised by the RIA or its related person. The Adopting Release notes that the SEC is unlikely to view a transaction as initiated by the RIA if the RIA assists in the secondary sale of an investor's fund interest at the unsolicited request of the investor. The distribution of the relevant opinion and the summary of material business relationships must be prior to the due date of the election for the transaction.

Notably, the Final Rules limit the scope of "adviser-led secondary transactions" from the Proposed Rules to transactions where investors are offered a **choice** between liquidity and rolling to a new fund. This excludes tender offers, which allow an investor to choose to remain in their existing fund investment. The SEC warned RIAs not to try and do indirectly what they cannot do directly, a warning that seems aimed at attempts to "game" the more limited definition of adviser-led secondary transaction by, for example, dividing a transaction into stages so that at no point is an investor directly presented with a choice between liquidity and rolling to a new fund. The SEC also clarified that the Rule will not apply to portfolio rebalancings or season and sell parallel structures.

Adviser-led secondaries were also a focus of the May 2023 amendments to Form PF (discussed here), which introduced a current report requirement for these transactions. While current market practice generally includes fairness opinions for investors participating in many adviser-led secondary transactions, advisers and investors may sometimes prefer lower cost alternatives such as pegging prices to third party bids or other independent sources because the cost for a fairness opinion is born by investors. The Final Rules do not allow investors that flexibility.

Scope and Grandfathering. As proposed, the Adviser-Led Secondaries Rule only applies to RIAs and their private funds clients, but not ERAs. It will not apply to SAFs. The Adopting Release clarifies that it does **not** apply to non-U.S. fund clients of offshore RIAs, regardless of whether they have U.S. investors. No grandfathering is included, regardless of what fund documents might provide with respect to alternate valuation methods and consent.

The Audit Rule

New rule 206(4)-10 (the "**Audit Rule**") requires RIAs to obtain an annual audit of each private fund that they advise (directly or indirectly). An audit will also be required promptly upon liquidation. In response to comments, the Audit Rule applies the audit requirements of the Custody Rule, abandoning parallel but modified requirements in the Proposed Rules. This relief may be short lived because the Custody Rule is itself subject to potential overhaul by the proposed Safeguarding Rule (discussed here). The SEC re-opened the comment period on the Safeguarding Rule when they adopted the Final Rules.

As with the Custody Rule, audited financials must be delivered to a private fund's investors within 120 days of the fund's fiscal year end, with an extension to 180 days for a fund of funds and 260 days for a fund of funds of funds. In a master-feeder structure, master fund financials may be attached to the feeder fund financials and delivered to investors in the feeder fund. However, the Audit Rule does not include the Custody Rule's exemptions from the surprise examination option. These include, for example, when an adviser either does not have custody of a private fund's cash and securities or has custody solely because of its authority to deduct advisory fees from client accounts. This will result in increased costs ultimately borne by investors and operational challenges for RIAs for private funds where audits have proven difficult.

The Adopting Release notes that, while the Audit Rule requires GAAP financial statements, financial statements may be prepared in accordance with other 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. However, RIAs still cannot use a surprise exam if their non-U.S. funds rely on financial statements that cannot be easily reconciled to

GAAP, and the Final Rules do not recognize any non-GAAP accounting standards (such as IFRS) as acceptable substitutes to GAAP without reconciliation.

In a welcome change for RIAs and the audit industry, the Final Rules drop the proposed requirement that an independent accountant notify the Division of Enforcement when issuing an audit report containing a modified opinion or when removing itself or being removed from consideration for being reappointed. Modified opinions remain subject to disclosure on Form ADV at the time audited financials are provided to investors. While the SEC dropped this requirement in order to align the Audit Rule with the Custody Rule, the auditor notice requirement remains part of the proposed Safeguarding Rule and so would apply through the incorporation of the Custody Rule if that proposal is adopted.

The SEC continues to assert that these audits are intended to both protect investors against misappropriation of fund assets and mitigate the conflicts of interest that arise when advisers determine the asset valuations that underlie the calculation of advisory fees and are used in sales practices. If those risks — and Enforcement cases, which the SEC cited extensively in the Adopting Release as justification for the Final Rules — continue despite the SEC's enforcement power under the antifraud rules and the Fiduciary Duty Guidance, the existing Custody Rule audit and surprise exam requirements, and these sales practices being subject to the Marketing Rule, we wonder when the SEC will consider its tool kit complete on the valuation topic.

Scope and Grandfathering. As proposed, the Audit Rule only applies to RIAs and their private fund clients, and not ERAs. It will not apply to SAFs. The Adopting Release confirms that the Audit Rule will **not** apply to the non-U.S. fund clients of offshore RIAs, regardless of whether they have U.S. investors.

In response to comments, the Adopting Release notes that RIAs can treat a special purposes vehicle ("**SPV**") as a separate client, or treat the SPV's assets as assets of the pooled investment vehicle(s) that it is advising indirectly through the SPV. For SPVs treated as separate clients, RIAs must distribute the SPV's audited financial statements to the pooled investment vehicle's beneficial owners. For SPVs consolidated with another private fund client, the SPV's assets must be part of that private fund's financial statement audit.

As proposed, the Final Rules include an exception for funds and RIAs not in a control relationship. Where a fund is not controlled by or under common control with the RIA, the RIA only needs to take "all reasonable steps" to cause the fund to undergo an audit that meets the Rule's requirements. This exception, however, does not apply to registered sub-advisers affiliated with primary advisers who are ERAs or who are offshore RIAs with non-U.S. private fund clients. As a result, offshore advisers must obtain audits for their non-U.S. funds where those funds are sub-advised by the offshore advisers' U.S. RIA affiliates. The Adopting Release acknowledges these sub-advisers but does not provide relief, stating that "all reasonable steps" would depend on the facts and circumstances, and that advisers are in the best position to evaluate their control relationships over private fund clients, and should be in a position to determine the appropriate steps to satisfy the standard based on their relationship with the private fund and the relevant control person. The SEC indicated that a sub-adviser with no affiliation to the general partner of a private fund could document its efforts by including or seeking to include the requirement in its sub-advisory agreement. Unfortunately, if the compliance period for the Marketing Rule's placement agent contractual provisions has taught the industry nothing else, it has brought into sharp focus the limits of a counterparty's willingness to accept responsibilities based on an adviser's onerous regulatory obligations. We expect sub-advisers will receive a similar cold shoulder.

The Audit Rule has no grandfathering and will apply to both new and existing funds. Like the Quarterly Statement Rule, the Audit Rule therefore overrides any contractually negotiated flexibility around audits in existing funds.

The Annual Review Rule and Recordkeeping

The Final Rules amend the Advisers Act Compliance Rule to require all RIAs to document the annual

review of their compliance policies and procedures in writing. The Adopting Release states that this compliance documentation is not protected by attorney-client privilege or similar doctrines. This is likely to invite challenges during exams because RIAs often have some documentation and information that is privileged so as to benefit from counsel review advice. In our experience, as long as critical documentation is provided to the SEC Staff, asserting privilege over other documentation should be reasonable.

The Final Rules require RIAs to retain copies of all quarterly statements, audited financial statements, fairness or valuation opinions, material business relationship summaries, and notices related to the Preferential Treatment Rule, along with a record of each addressee and the corresponding date(s) sent. The Final Rules dropped the proposed recordkeeping requirement for delivery method and addresses. The recordkeeping requirements also apply to current **and prospective** private fund investors. These changes, when paired with the Form PF Proposal, continue the trend by this SEC towards a proscriptive approach dominated by forms, defined methodology and templates that seem aimed at assisting SEC Staff in examinations and investigations as they continue to crack down on the private fund industry.

Compliance Dates

The Final Rules have staggered compliance dates based on an adviser's "private fund assets under management" as used in Form PF ("**Private Fund AUM**"). The compliance clock began on September 14, 2023 when the Final Rules were published in the Federal Register.

Rule	**Advisers with $1.5B or greater Private Fund AUM**	**Advisers with less than $1.5B Private Fund AUM**
Quarterly Statements	March 14, 2025	March 14, 2025
Restricted Activities	September 14, 2024	March 14, 2025
Preferential Treatment	September 14, 2024	March 14, 2025
Adviser-led Secondaries	September 14, 2024	March 14, 2025
Audit	March 14, 2025	March 14, 2025
Annual Review/Recordkeeping	November 13, 2023	November 13, 2023

The Audit Rule and Quarterly Statement Rule received longer transition periods across the board in recognition that RIAs may need time to enter into new or renegotiate existing contracts with service providers.

While the compliance requirements of the Final Rules have generally been seen as a barrier to entry for new advisers, given the costs involved with compliance, they will also require a substantial compliance investment by existing advisers who must bring a sizable volume of existing funds into compliance.

…

CLEARY GOTTLIEB

Rule / Amendment	Application	Legacy Treatment	Compliance Date
Quarterly Statements – Requires the following disclosure, broken out by line item and presented both before and after any offsets, rebates or waivers: • **Fund table** disclosing (1) all compensation, fees and other amounts allocated or paid to the adviser or its "related persons" by the fund, (2) all fees and expenses allocated to or paid by the fund and (3) any offsets or rebates carried forward. • **Portfolio investment table** with a detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment to the adviser or its related persons, with separate line items for each. • **Performance** information, including: For "liquid funds": o Annual net returns for each fiscal year over the last 10 fiscal years or since inception, whichever is shorter; o Average net total return over a 1, 5 and 10-fiscal-year period; and o Cumulative net total return for the current fiscal year as of most recent fiscal quarter end. For "illiquid funds": o Gross and net full fund IRR and MOIC; o Gross only IRR and MOIC for the realized and unrealized portions of the portfolio; and o Statement of contributions and distributions. **Illiquid fund performance figures must computed both with and without the impact of any fund-level subscription facilities.** **Timing for delivery** – 45 days after first, second and third fiscal quarters and 90 days after fiscal year end; 75 and 120 days, respectively, for fund of funds.	– RIAs only – Only U.S. funds of offshore RIAs – SAFs excluded	None	March 14, 2025

<table>
<tr><th>Rule / Amendment</th><th>Application</th><th>Legacy Treatment</th><th>Compliance Date</th></tr>
<tr><td>Restricted Activities – An adviser may not:

1. Charge/allocate to a fund fees or expenses associates with a governmental/regulatory investigation of the adviser or its related person, <u>unless</u> the adviser obtains <u>written consent</u> from a majority in interest of the fund’s investors who are not related persons of the adviser.

Notwithstanding the above, in no circumstances may an adviser charge/allocate fees or expenses relating to an investigation resulting in sanctions for violations of the Advisers Act or its rules, with no exceptions.

2. Borrow money, securities or other private fund assets, or receive a loan or extension of credit from a fund client, <u>unless</u> the adviser (i) distributes a written description of the material terms of the borrowing, loan or extension of credit to each investor of the fund and (ii) obtains <u>written consent</u> from at least a majority in interest of the fund’s unrelated investors.

3. Charge/allocate to a fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, or the adviser or its related persons, <u>unless</u> the adviser provides the investors with <u>notice</u> of such fees or expenses, including the dollar amount thereof, within 45 days after the end of the quarter in which the charge occurs.

4. Reduce an adviser clawback by actual, potential or hypothetical taxes, <u>unless</u> the adviser distributes <u>notice</u> to the investors of the aggregate dollar amounts of the before and after-tax amounts of the clawback within 45 days after the end of the quarter in which the clawback occurred.

5. Charge/allocate fees or expenses related to a portfolio investment or potential portfolio investment on a non-pro rata basis where multiple funds and clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment, <u>unless</u> (i) the non-pro rata allocation</td><td>– RIAs & ERAs

– Only U.S. funds of offshore advisers

– SAFs excluded</td><td>Partial – Legacy treatment applies only to restricted activities <u>requiring consent</u> (i.e., investigations fees/expenses and borrowing from fund clients).

<u>No</u> grandfathering for restricted activities requiring disclosure.</td><td>September 14, 2024 for advisers with $1.5B or more of AUM

March 14, 2025 for advisers with less than $1.5B of AUM</td></tr>
</table>

Rule / Amendment	Application	Legacy Treatment	Compliance Date
is fair and equitable under the circumstances and (ii) before charging/allocating the fees or expenses to the fund, the adviser distributes written **notice** to each investor of the non-*pro rata* charge/allocation and a description of how it is fair and equitable under the circumstances.			
Preferential Treatment – • *Prohibited Preferential Redemptions* – Advisers may not grant an investor in a private fund or a "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 fund or in a similar pool of assets (i.e., a pooled investment vehicle other than a registered investment company 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). o Exceptions where (i) the ability to redeem is required by applicable laws, rules, regulations or orders or (ii) the adviser has offered and will offer the same redemption ability to all other investors in the private fund and any similar pool of assets. • *Prohibited Preferential Transparency* – Advisers may not provide information regarding portfolio holdings or exposures of the private fund or a "similar pool of assets" to any investor in the private fund 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 similar pool of assets. o Exception where 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.	– RIAs & ERAs – Only U.S. funds of offshore advisers – SAFs excluded	**Partial** – the prohibitions do not apply to contractual agreements of operating funds entered into before the compliance date, if the prohibitions would require the amendment of such agreements. No grandfathering with respect to the disclosure requirements.	September 14, 2024 for advisers with $1.5B or more of AUM March 14, 2025 for advisers with less than $1.5B of AUM

<table>
<tr><th>Rule / Amendment</th><th>Application</th><th>Legacy Treatment</th><th>Compliance Date</th></tr>
<tr><td>Disclosure of Preferential Treatment – Advisers may not provide any preferential treatment to any investor in a private fund, unless it provides the following disclosure:
<u>Before</u> a prospective investor’s investment in a private fund, written disclosure regarding preferential treatment related to any “material economic terms” that the adviser or its related persons are providing to other investors in the same fund;
<u>Post-closing</u> written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund to current investors “as soon as reasonably practicable” following (i) the end of the private fund’s fundraising period if the fund is illiquid (ii) the investor’s investment in the private fund if the fund is liquid; and thereafter
<u>Annual</u> written information about any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice.</td><td></td><td></td><td></td></tr>
<tr><td>Audit – Advisers must cause the private funds they advise (directly or directly) to undergo a financial statement audit in accordance with the audit provisions (and related requirements for delivery of audited financial statements) of the Custody Rule.
Limited exception for private funds the adviser does not control and is not controlled by or in common control with, in which case the adviser only needs to take “all reasonable steps” to cause the fund to undergo an audit that meets the rule’s requirements.
Any future changes to the Custody Rule, including but not limited to those in the Safekeeping Rule proposal, could be incorporated by reference into this Audit Rule.</td><td>– RIAs only
– Only U.S. funds of offshore RIAs
– SAFs excluded</td><td>None</td><td>March 14, 2025</td></tr>
</table>

Rule / Amendment	Application	Legacy Treatment	Compliance Date
Adviser-Led Secondaries – In connection with any adviser-led secondary transaction, an adviser must: • Obtain and distribute to the investors in the fund either (i) a fairness opinion or (ii) a valuation opinion from an independent opinion provider; and • Prior to the due date of the election form, prepare and distribute to the investors a written summary of any material business relationships the adviser or its related persons has had within the 2-year period prior to issuance of the opinion.	– RIAs only – Only U.S. funds of offshore RIAs – SAFs excluded	None	September 14, 2024 for advisers with $1.5B or more of AUM March 14, 2025 for advisers with less than $1.5B of AUM
Annual Review / Recordkeeping – Requires advisers to document in writing, no less than annually, the adequacy of their policies and procedures and effectiveness of their implementation.	– RIAs only – Only U.S. funds of offshore RIAs – SAFs excluded	None	November 13, 2023