Hogan Lovells

Private Capital Alert
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This is a commercial communication from Hogan Lovells. See note below.

SEC adopts final rule implementing private fund reforms

The U.S. Securities and Exchange Commission (SEC) adopted final private fund rules under the U.S. Investment Advisers Act of 1940 (the Advisers Act) on August 23, 2023. Although the final rules are significantly less onerous than proposed in February 2022, they establish new requirements that will impact all private fund advisers, including both registered investment advisers (RIAs) and, in some cases, exempt reporting advisers (ERAs). In particular, while the SEC had proposed to ban outright certain categories of prohibited activities, the final rules adopt a disclosure (and in some cases investor consent) approach and also "grandfather" most existing funds from the prohibited activities provisions.

The new rules generally take effect 18 months after publication in the Federal Register, with certain of the prohibited activities rules subject to an effective date of 12 months after publication for fund groups with private fund assets under management of $1.5 billion or more.

Taken together, the new rules represent one of the most far-reaching reforms of private fund regulation since adoption of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Noting that the assets under management by private fund advisers rose from $9.8 trillion in 2012 to $26.6 trillion in 2022, the SEC justified its rulemaking in part on the increasing exposure of many retirement plans to private funds, as well as rising retail investor interest in private funds.

The final private funds rules (including the SEC adopting release) are available in full here.

I. Summary of New Rules and Overview

The final rules impose five new requirements on private fund advisers:

- **Restricted Activities Rule.**[1] All private fund advisers (RIAs and ERAs alike) will be required to provide disclosures – and in some cases obtain investor consent – for a set of five "restricted activities" that include (i) charging certain regulatory investigation fees or expenses; (ii) charging certain regulatory or compliance fees and expenses; (iii) charging of *non-pro rata* fees and expenses; (iv) returning only after-tax amounts of GP clawback; and (v) borrowing from private fund clients.
- **Quarterly Statement Rule.**[2] All SEC-registered private fund advisers must provide to fund investors information about each private fund's fees, expenses and portfolio performance, with different standards for "liquid funds" (generally hedge funds) and "illiquid funds" (generally private equity, venture capital and most real estate and credit funds), each as defined in the final rule. Statements will generally be due within 45 days after quarter-end and 90 days after year-end, except that the deadlines for funds of funds will be 75 and 120 days, respectively.
- **Audit Rule.**[3] All SEC-registered private fund advisers must cause each private fund they advise to undergo an annual financial statement audit, which the final rule requires to be prepared in accordance with the provisions of Rule 206(4)-2, popularly known as the "Custody Rule." Advisers must provide the audited financial statements to fund investors within 120 days (or within 180 days for funds of funds).

1 Rule 211(h)(2)-1. In addition, Rule 211(h)(1)-1 is a definitional rule that applies to the three additional rules adopted under Section 211(h).
2 Rule 211(h)(1)-2.
3 Rule 206(4)-10. Note that this is the only rule adopted under the longstanding and broad anti-fraud provisions of Section 206, rather than the Dodd-Frank-era Section 211(h).

- **Adviser-Led Secondaries Rule.**[4] SEC-registered private fund advisers conducting an adviser-led secondary transaction must satisfy specific disclosure requirements, one of which shall be delivery to existing investors of (i) a fairness opinion or (ii) a valuation opinion, along with enhanced disclosures about conflicts of interest with the opinion provider. The option to utilize a valuation opinion rather than a fairness opinion responds to sharp criticism of this proposal from the private funds industry.
- **Preferential Treatment Rule.**[5] All private fund advisers (RIAs and ERAs alike) will be prohibited from providing preferential treatment to large investors with respect to redemption rights or access to information that could reasonably be expected to have a material, negative effect on other investors. In addition, advisers will be required to disclose other types of preferential treatment (such as many side letter provisions), both to prospective investors and to all existing fund investors.

Recordkeeping and compliance rule amendments. The final rules make several corresponding changes to the books and records requirements applicable to RIAs. They also adopt a provision requiring written documentation of the annual compliance review required of registered advisers under Rule 206(4)-7 (the RIA compliance rule), a provision that will become effective 60 days after publication in the Federal Register.

Scope for US RIAs, US ERAs and non-US advisers. Generally, the scope of the rules' applicability has not changed from the SEC's proposal. As summarized below, the Quarterly Statement Rule, the Audit Rule and the Adviser-Led Secondaries Rule apply only to RIAs and not to ERAs; the Restricted Activities Rule and the Preferential Treatment Rule apply to all advisers, including ERAs. Changes to the annual compliance review and recordkeeping rules also apply only to RIAs.[6]

Offshore advisers (RIAs and ERAs alike) should note that the SEC makes clear that none of these new rules will be applied to non-U.S. private fund clients of offshore RIAs or ERAs, regardless of whether such non-U.S. private funds have U.S. investors.

SEC rationale. Since Dodd-Frank, which subjected a far greater number of private fund advisers to SEC registration, the SEC has steadily extended its oversight of private fund operations after conducting thousands of examinations. The SEC views three primary factors as contributing to investor protection risks and harms: lack of transparency; conflicts of interest; and lack of robust fund governing mechanisms.

In its adopting release, the SEC explains at length why it believes the reforms are necessary and, in anticipation of possible litigation over the scope of the reforms, why the SEC is empowered to enact these rules – both under the broad anti-fraud protections of Section 206(4) of the Advisers Act and newer public interest regulatory powers provided under Section 211(h) granted under Dodd-Frank. In particular, three of the new rules are adopted under Section 211(h)(2), which authorizes the SEC to prohibit or restrict certain sales practices, conflicts of interest, or compensation schemes that it deems contrary to the public interest and the protection of investors. In contrast, the Republican-appointed commissioners, who voted against adoption, view the proposals as regulatory overreach and not required for the sophisticated investors to whom most private fund interests are offered.

4 Rule 211(h)(2)-2.

5 Rule 211(h)(2)-3.

6 In a departure from the proposed rule, the five reforms will not apply to certain securitized asset funds (SAFs), which are those private funds whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders. SAFs do not include traditional hedge, private equity, venture capital, real estate or credit funds.

<table>
<tr><th></th><th>Quarterly Statement Rule</th><th>Audit Rule</th><th>Adviser-Led Secondaries Rule</th><th>Restricted Activities Rule</th><th>Preferential Treatment Rule</th></tr>
<tr><td>Rule</td><td>211(h)(1)-2</td><td>206(4)-10</td><td>211(h)(2)-2</td><td>211(h)(2)-1</td><td>211(h)(2)-3</td></tr>
<tr><td>Registered investment advisers</td><td>Detailed quarterly disclosure about fees and expenses (generally within 45 days after quarter-end, 90 days after year-end), portfolio company reimbursement, plus net/gross performance data, detailed for liquid and illiquid funds</td><td>All private funds must obtain an annual financial statement audit (substantially similar to the annual audit described under the Custody Rule). Surprise custody examinations under the Custody Rule would not satisfy new requirement.</td><td>In any adviser-led secondary transaction, adviser must obtain either a fairness opinion or valuation opinion. In addition, the adviser must disclose any material business relationships (over the prior two years) with the provider of such opinion.</td><td rowspan="2">Advisers cannot, without majority LP consent, (i) charge private funds for regulatory investigation costs or (ii) borrow from a private fund client; in addition, cannot, without disclosures, (iii) charge regulatory expenses, (iv) reduce GP clawback to after-tax amount or (v) charge expenses on a non-pro rata basis (and then with a fair and equitable basis).</td><td rowspan="2">No preferential treatment in respect to redemptions or providing additional transparency / information rights that have a material, negative effect on other investors.

Other preferential treatment (i.e. side letters or side arrangements) is prohibited unless disclosed to investors and prospective investors.</td></tr>
<tr><td>Exempt reporting advisers</td><td colspan="3">Not applicable.</td></tr>
<tr><td>Key differences from proposed rules</td><td>Minor changes; simplified definitions of “illiquid fund” and “liquid fund.” (which dictate the reporting required).</td><td>Harmonized more closely with the financial statement audit provisions of the Custody Rule.</td><td>Proposed rule mandated a fairness opinion; the final rule allows a choice of fairness or valuation opinions.</td><td>Proposal flatly prohibited the five restricted activities; also prohibited LPs from indemnifying GP from negligence and other matters.</td><td>Minor changes; disclosures to prospective investors limited to preferential treatment in material economic terms.</td></tr>
<tr><td>Effective date</td><td colspan="2">18 months after date of publication in the Federal Register.</td><td colspan="3">12 months after date of publication in the Federal Register for advisers with $1.5 billion or more in private fund assets under management; 18 months if less than $1.5 billion (i.e., no sooner than Q3 2024 and Q1 2025, respectively)</td></tr>
<tr><td>Legacy fund application (or “grand-fathering”)</td><td colspan="3">Not applicable.</td><td colspan="2">Neither (i) restricted activities requiring LP consent nor (ii) flat prohibitions on preferential treatment will apply to any 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 if the rule would require the parties to amend such governing agreements.</td></tr>
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II. Restricted Activities Rule – Rule 211(h)(2)-1

The new Restricted Activities Rule[7] requires that private fund advisers (RIAs and ERAs alike) will be prohibited from engaging in certain practices or charging certain fees or expenses without investor disclosure and/or consent.

This is a significant change from the proposed rule, which would have prohibited these practices, fees and expenses outright. Taken together, the final rule represents a major relaxation of the SEC's proposal, which attracted significant criticism from fund sponsors and other industry participants.

As adopted, a private fund adviser may not, directly or indirectly, do any of the following with respect to the private fund, or any investor in the fund:

- ***Regulatory investigation expenses – majority consent required:*** Charge or allocate to the private fund fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, unless (except as noted below) the investment adviser requests each investor of the fund to consent to, and obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser for, such a charge or allocation. An adviser may not charge or allocate to the 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 its rules, regardless of whether investors have consented to such expenses;[8]
- ***Regulatory compliance expenses – disclosure required:*** Charge or allocate to the private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the adviser or its related persons, unless the investment adviser distributes a written notice of any such fees or expenses, and the dollar amount thereof, 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;[9]
- ***After-tax GP clawback – disclosure required:*** Reduce the amount of an adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders, 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 actual, potential, or hypothetical taxes within 45 days after the end of the fiscal quarter in which the adviser clawback occurs;[10]
- ***Charge expenses on a non-pro rata basis – disclosure required and must be fair and equitable:*** Charge or allocate 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, 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 investment 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;[11] and
- ***Private fund client borrowing – majority consent required:*** Borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client, 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 that are not related persons of the adviser.[12]

Notably, the two provisions that require investor consent (relating to regulatory investigation expenses or client borrowing) shall not apply if entered into by a private fund that commenced operations prior to the applicable compliance date if compliance would require the parties to amend a governing agreement.[13]

7 Rule 211(h)(2)-1. In addition, Rule 211(h)(1)-1 is a definitional rule that applies to the three additional rules adopted under Section 211(h).
8 Rule 211(h)(2)-1(a)(1).
9 Rule 211(h)(2)-1(a)(2).
10 Rule 211(h)(2)-1(a)(3).
11 Rule 211(h)(2)-1(a)(4).
12 Rule 211(h)(2)-1(a)(5).
13 Rule 211(h)(2)-1(b).

The five restricted activities are summarized in the following chart:

Rule	Restricted Activity	Required Mitigation
Rule 211(h)(2)-1(a)(1)	Charge/allocate expenses associated with a regulatory investigation (absolute prohibition on expenses associated with a regulatory investigation resulting in sanction for Advisers Act violations).	Written consent from a majority in interest of the investors of the private fund.
Rule 211(h)(2)-1(a)(2)	Charge/allocate regulatory or compliance fees or expenses, or fees or expenses associated with an examination.	Written notice to investors of any such fees or expenses, and the dollar amount thereof, in writing within 45 days after the end of the fiscal quarter in which the charge occurs.
Rule 211(h)(2)-1(a)(3)	Reduce amount of GP/adviser clawback to after-tax amount, whether actual, hypothetical or potential taxes.	Written notice to investors setting forth 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 GP/ adviser clawback occurs.
Rule 211(h)(2)-1(a)(4)	Charge/allocate fees or expenses to multiple funds on a *non-pro rata* basis related to the same portfolio investment .	Must have a fair and equitable basis to do so in all cases. Written notice to investors prior to charge/ allocation describing why *non-pro rata* is fair and equitable.
Rule 211(h)(2)-1(a)(5)	Borrow money, securities or other private fund assets, receive loan or extension of credit, in each case from a private fund client.	Written consent from a majority in interest of the investors of the private fund after providing a written description of the material terms.

Non-Pro Rata Fees

Some of the regulatory concerns animating the proposed rule's prohibitions are reflected in aspects of the final rules. Alone among the five restricted activities, all private fund advisers are expressly prohibited from charging fees and expenses to multiple funds on a *non-pro rata* basis, even with disclosure, if such *non-pro rata* basis is not "fair and equitable."

For example, the SEC remains concerned that where a main fund and a co-investment fund invest (or propose to invest) in the same portfolio investment, the main fund may wind up bearing the full costs, while the co-investment vehicle (which may include favored or larger investors and may not charge fees or carried interest) will bear none of the costs. This, the SEC, notes, is a conflict of interest that may be contrary to the protection of investors.

By "fair and equitable," the SEC clarifies that this standard does not necessarily mean that all investors must be treated equally. Determining whether a particular allocation is fair and equitable will necessarily depend on the relevant facts and circumstances. The SEC provides the following non-exclusive examples in its adopting release of fair and equitable allocation that may be charged on a *non-pro rata* basis: some expenses relating to a specific security held by one private fund client; relating to a bespoke structuring arrangement for a particular private fund (for example, the additional incremental costs of a foreign feeder fund or other expenses related to individualized tax, regulatory, accounting or other legal matters);[14] and fees reflecting that one client may receive a greater benefit relative to other clients (e.g. the potential benefit of certain insurance policies).

Rejected Prohibitions

The SEC also removed two proposed prohibitions altogether:

- a proposed prohibition on charging a portfolio investment for monitoring, servicing, consulting or other fees in respect of any services the adviser does not, or does not reasonably expect to, provide to the portfolio investment (on the basis, in the SEC's view, that such activity is already inconsistent with an adviser's fiduciary duty);[15] and

14 Private fund advisers should note that the SEC's statements in the adopting release show that the SEC continues to believe that broken-deal expenses for an unconsummated portfolio investment must be shared among private funds and potential co-investors, rather than be borne solely by the main fund and its investors.

15 The SEC in 2019 released an interpretive order clarifying its view that all advisers have a fiduciary duty to their clients (including private fund investors) that entails both a duty of care and a duty of loyalty. See: https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf. The SEC reiterated in its adopting release that it is reaffirming and

- a proposed prohibition on a private fund adviser, directly or indirectly, seeking reimbursement, indemnification, exculpation or limitation of liability by the private fund or its investors for a breach of fiduciary duty, willful malfeasance, bad faith, negligence, or recklessness in providing services to the private fund (based on SEC's view that many of the activities covered by such indemnification are also inconsistent with fiduciary duty, and that the anti-fraud provisions of Section 206 of the Advisers Act are sufficient to cover fraudulent behavior).

The indemnification prohibition, in particular, had drawn widespread concern across the private fund industry.

III. Quarterly Statement Rule – Rule 211(h)(1)-2

The new Quarterly Statement Rule requires that registered private fund advisers (i) provide investors with quarterly statements detailing all fees and expenses paid by the private fund during the reporting period, (ii) disclose information regarding compensation or other amounts paid by the private fund's portfolio investments to the adviser or any of its related persons, and (iii) disclose information regarding the private fund's performance.[16]

The SEC's rationale for the new rule is to facilitate simple and clear disclosure to investors. While it is common for private funds advisers to provide quarterly fund updates, the new rule will harmonize a baseline of required reporting, in a timely, detailed and consistent manner. The SEC underscores an emphasis on comparability and standardization as key features of the disclosure approach established by the new Quarterly Statement Rule.

Quarterly reports will be due, for most registered private fund advisers, within 45 days after the end of the first three fiscal quarters and 90 days after the end of the fiscal year; in a departure from the proposed rule, funds of funds will have 75 days after each quarter-end and 120 days after year-end to provide the reports.[17] Quarterly reporting obligations begin, in the case of a newly formed private fund, after its first two full fiscal quarters of operating results. Initial quarterly statement should cover both quarters.

Fees and Expenses

The Quarterly Statement Rule requires, for each private fund, a table that sets forth key fees and expenses as follows:[18]

- a detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or its related persons by the private fund during the reporting period, 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;[19]
- a detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and
- the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the adviser or its related persons.[20]

Notably, in describing the categories of fees and expenses to be disclosed quarterly, the SEC clarified that the rule does not permit the exclusion of *de minimis* fees or expenses, and a "miscellaneous" category will be insufficient disclosure.

In a change from the proposed rule, many of the quarterly reporting requirements capture not only fees and expenses paid by the fund, but also those allocated to the fund, during the reporting period. For example, a

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clarifying its views on investment adviser fiduciary duties in its commentary on why these two rejected prohibitions are, in its view, unnecessary.

16 Rule 211(h)(1)-2.

17 Rule 211(h)(1)-2(a).

18 Rule 211(h)(1)-2(b).

19 Under Rule 211(h)(1)-1, "performance-based compensation" is defined as allocations, payments or distributions of capital based on the private fund's (or any of its investments') capital gains, capital appreciation and/or other profit. This definition, of course, would include all carried interest distributions made to an adviser and/or its related persons, as well as investment income, and it would include both cash and non-cash compensation, such as in-kind distributions of securities.

20 For example, this would require disclosure of any management fee offsets as a result of fee income received by the fund, or the placement agent fees or excess organizational expenses, both before and after the management fee offset. The same would presumably apply to management fee waiver arrangements whereby an adviser chooses to receive part of its management fee as a profits interest in the fund itself.

co-investment vehicle without the ability to call additional capital might be allocated expenses for years until such expenses are actually paid following a realization event.

Portfolio Company Compensation

The Quarterly Statement Rule also requires, for each private fund, a separate table for the private fund's "covered portfolio investments."[21] The table must disclose a detailed accounting of all portfolio investment compensation allocated or paid to the adviser or its related persons by a covered portfolio investment during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented *both before and after* the application of any offsets, rebates or waivers.[22]

The reporting obligation involves only covered portfolio investments, which are those defined to have paid portfolio investment compensation to the adviser. If, for any quarter, there is no portfolio investment compensation paid to the adviser, there will be nothing to report with respect to a fund's portfolio investments.[23] As broadly defined, "portfolio investment compensation" means any compensation, fees and other amounts allocated or paid to the adviser or its related persons by the portfolio investment attributable to the private fund's interest in such portfolio investment, including, but not limited to, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, director, trustee or similar fees or payments.

Performance

Quarterly reporting must include certain performance information that varies based on a private fund's characterization as either an "illiquid fund" or "liquid fund."

In a departure from the proposed rule, the final rule simplifies the definition of "illiquid fund" as a private fund that (i) is not required to redeem interests upon an investor's request and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund. A "liquid fund" is any private fund not defined as an illiquid fund. Most hedge funds will fall under the "liquid fund" category, while most private equity, venture capital and credit funds will fall under the "illiquid fund" category.

Liquid funds must report as follows:

- annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever time period is shorter;[24]
- average annual net total returns over the one-, five-, and 10-fiscal-year periods; and
- cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.

Illiquid funds must report as follows:

- all of the following performance measures, shown since inception through the end of the quarter covered by the quarterly statement and computed with and without the impact of any fund-level subscription facilities:[25] [26]
  - — gross IRR and gross MOIC,
  - — net IRR and net MOIC, and

21 Under Rule 211(h)(1)-1, "portfolio investment" means any entity or issuer in which the private fund has directly or indirectly invested. A "covered portfolio investment" means any portfolio investment that allocated or paid the adviser or its related persons "portfolio investment compensation" during the reporting period. This includes, for funds of funds, not only their direct fund investments, but also each fund's portfolio holdings.

22 Rule 211(h)(1)-2(c).

23 The SEC proposed, but did not adopt, an additional requirement to disclose the private fund's ownership of each covered portfolio investment.

24 The SEC does not include a definition of "net total return" because it views a single definition as inappropriate, given the diversity of structures and strategies across all types of liquid funds.

25 Under the Rule 211(h)(1)-1 definitions, "fund-level subscription facilities" means any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness incurred by the private fund that is secured by the unfunded capital commitments of the private fund's investors. These facilities generally do not include fund-level guarantees of portfolio investment indebtedness, which are generally not put into place to enable delayed calling of investor capital, even if technically the fund may ultimately be required to cover the shortfall to satisfy the guarantee.

26 Requiring performance information both with and without facility leverage represents a change from the proposal that would have required only performance data without the impact of fund-level subscription facilities. For performance measures with unlevered returns, the rule requires advisers to calculate performance measures as if the private fund called investor capital, rather than drawing down on fund-level facilities (and, the SEC clarifies, for the purpose of this calculation, advisers should exclude fees and expenses associated with the subscription facility, such as interest expense, when calculating net performance figures). For performance measures with levered returns, the rule requires advisers to calculate performance measures reflecting the actual capital activity from both investors and fund-level subscription facilities, including any activity prior to investor capital contributions as a result of the fund drawing down on the fund-level facilities.

— gross IRR and gross MOIC for the realized and unrealized portions of the fund's portfolio, with the realized and unrealized performance shown separately; and

- a statement of contributions and distributions for the fund, which is defined as a document that presents:
  - — all capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and
  - — the net asset value of the private fund as of the end of the reporting period.

For the performance disclosures, the SEC defines the various concepts of IRR and MOIC as follows (which are in the form proposed):[27]

- "internal rate of return" means the discount rate that causes the net present value of all cash flows throughout the life of the fund to be equal to zero.
- "multiple of investment capital" means, as of the end of each applicable quarter, (1) the sum of (i) the unrealized value of the illiquid fund and (ii) the value of all distributions made by the illiquid fund, (2) divided by the total capital contributed to the illiquid fund by its investors.
- "gross IRR" and "gross MOIC" mean, respectively, the internal rate of return or multiple of investment capital, in each case that is calculated gross of all fees, expenses, and performance-based compensation borne by the private fund.
- "net IRR" and "net MOIC" mean, respectively, the internal rate of return or multiple of investment capital, in each case that is calculated net of all fees, expenses, and performance-based compensation borne by the private fund.

The gross/net requirement matches the emphasis on dual gross and net performance presentation for RIA advertisements as set forth in the Marketing Rule adopted by the SEC in December 2020, which took effect in November 2022.[28]

The quarterly statement must include the date as of which the performance information is current and prominent disclosure of the criterial used and assumptions made in calculating the performance.

In its adopting release, the SEC clarified that the adviser's (and its related persons) interests should be excluded when calculating performance because such interests do not generally pay management fees or carried interest, so their inclusion can, therefore, make the disclosure misleading.

The SEC cautions that if an adviser is currently unable to receive information from a fund's underlying portfolio investments in a sufficiently timely manner to enable it to prepare and deliver the quarterly statements, the adviser will need to consider contractual or other types of arrangements to attain this information in a timely manner. Nonetheless, in setting firm deadlines, the SEC clarifies that failure to deliver quarterly statements on time would not provide a basis for enforcement action so long as the adviser reasonably believed that the quarterly statement would be distributed by the applicable deadline and the adviser delivers the quarterly statement as promptly as practicable thereafter.

Other Requirements

The quarterly statement itself must include prominent disclosure about the manner in which all amounts are calculated and, in particular, must include cross-references to the section of the private fund's organizational and offering documents that set forth the applicable calculation methodology.[29] This disclosure will be especially important in informing clients how a liquid fund defines "net total returns," for example, or how an illiquid fund defines each of "realized" and "unrealized" investments, which may vary widely across various investment strategies. Moreover, an illiquid fund would need to disclose the use of any assumed fee rates, including whether the adviser is using fee rates set forth in the fund documents, whether it is using a blended rate or weighted average that would factor in any discounts, or whether it is using a different method for calculating net performance. The SEC's adopting release strongly suggests that mere footnote disclosure would be insufficient,

27 Rule 211(h)(1)-1.
28 Rule 206(4)-1, which replaced the old Rule 206(4)-1 (the "advertising rule") and old Rule 206(4)-3 (the "cash solicitation rule").
29 Rule 211(h)(1)-2(d).

but indicating instead that the assumptions must be provided so that investors can readily understand the performance information being provided.

An adviser must consolidate quarterly reporting for similar pools of assets to the extent doing so would provide more meaningful information to the private fund's investors.[30] The SEC clarified in its adopting release that it will not provide specific clarification, but rather instruct advisers to apply the principles-based approach to their fund structures. For example, this might mean that a standard master-feeder structure would provide only quarterly reporting at the master fund level, or that a group of affiliated parallel funds would receive consolidated information, not quarterly reporting for each particular parallel fund. Each decision, however, will be based on the particular facts and circumstances of each fund structure.

IV. Audit Rule – Rule 206(4)-10

The new Audit Rule[31] requires that an SEC-registered private fund adviser cause each private fund that it advises, directly or indirectly, to undergo a financial statement audit that meets the audit requirements of what is generally known as the limited partnership exception to the Custody Rule[32] and to cause audited financial statements to be delivered in accordance with the Custody Rule.[33]

The SEC says it adopted this rule to mitigate the conflicts of interest between an adviser and the private fund, with the audit serving as an important check on the adviser's valuation of private fund assets, which may affect the amount of management fee paid to an adviser.

The new Audit Rule essentially renders meaningless the surprise examination option under the Custody Rule for RIAs who advise only private funds, because the Audit Rule will now require an annual audit.[34] Conversely, because many RIAs already choose to comply with the annual audit requirement under the Custody Rule (rather than undergo the surprise examination), the new Audit Rule will not materially change operations for many RIAs.

The audit requirement, as proposed, was generally based on the annual audit requirement that many private funds currently use to comply with the Custody Rule under the Advisers Act. The final Audit Rule, however, harmonizes far more closely with the audited financial statements requirements under the Custody Rule,[35] thereby simplifying compliance with the Audit Rule. Under the new rule:

1. the audit must be performed by an independent public accountant subject to standards of independence under Regulation S-X and registered with and subject to regular inspection by the Public Company Accounting Oversight Board;
2. the audit must meet the definition of audit under Regulation S-X;
3. audited financial statements must be prepared in accordance with U.S. generally accepted accounting principles (GAAP); and

30 Rule 211(h)(1)-2(f).
31 Rule 206(4)-10. Note that this is the only rule adopted under the longstanding and broad anti-fraud provisions of Section 206, rather than the Dodd-Frank era Section 211(h).
32 Rule 206(4)-2(b)(4)(i) through (iii).
33 Rule 206(4)-2(c).
34 The SEC in February 2023 proposed an overhaul of the Custody Rule that would replace it with what the SEC calls the Safeguarding Rule (proposed Rule 223-1). The SEC has reopened the comment period for that proposal in light of the final adoption of the Audit Rule. The Safeguarding Rule would broaden the existing Custody Rule to include all assets held in an advisory account and not merely funds and securities (i.e. digital currencies, real estate or other commodities). As currently proposed, however, the Safeguarding Rule would not materially change the audit requirements currently established by the Custody Rule (other than to require non-US client financial statements to be reconciled with US GAAP).
35 The Custody Rule currently imposes certain requirements on RIAs with respect to custody of client funds or securities to protect client assets from loss, theft or misappropriation, including the appointment of a qualified custodian, such as a bank or registered broker-dealer, to maintain client assets and securities. If an RIA, advising a limited partnership or similar pooled investment vehicle subject to audit, and provides annually audited financial statements prepared in accordance with U.S. GAAP within 120 days (or 180 days for a fund of funds), the RIA need not comply with certain other provisions of the Custody Rule.

4. annually within 120 days of the private fund's fiscal year-end (or 180 days after the fiscal year-end for a fund of funds) and promptly upon liquidation, the audited financial statements must be delivered to investors (as opposed to merely "promptly" as the SEC originally proposed).[36]

Financial statements of private funds organized under non-U.S. law or that have a general partner or manager with a principal place of business outside the United States are required to contain information substantially similar to statements prepared in accordance with U.S. GAAP and any material differences must be reconciled to U.S. GAAP.

Some advisers may not control the private funds that they advise, nor might be controlled by or under common control with such private funds. In those cases, the SEC requires that the adviser take all reasonable steps to cause its private fund client to undergo an audit that satisfies the rule.[37]

V. Adviser-Led Secondaries Rule – Rule 211(h)(2)-2

The new Adviser-Led Secondaries Rule requires that any SEC-registered adviser conducting an adviser-led secondary transaction with respect to any private fund that it advises shall:[38]

- obtain and distribute to investors in the private fund either a fairness opinion or valuation opinion from an independent opinion provider;[39] and
- prepare, and distribute to investors in the private fund, a written summary of any material business relationships the adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider.[40]

The SEC explains it adopted this rule to provide a 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. In particular, such conflicts are difficult to mitigate because the adviser typically are involved on both sides of the transaction.

As proposed, the SEC would have required a fairness opinion in all cases, while the final rule gives advisers an option to choose between either a fairness opinion or a valuation opinion.

The SEC defines an "adviser-led secondary transaction" as any transaction initiated by the adviser or any of its related persons that offers private 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.[41] Whether a transaction meets this definition, the SEC states, necessarily requires a facts-and-circumstances analysis, and the definition is designed to remain evergreen as secondary transactions continue to evolve. For example, a transaction would not be initiated by the adviser if the adviser assists in the secondary sale of an investor's fund interest, at the unsolicited request of the investor. The SEC reiterated that the definition should generally not inadvertently capture such transactions as rebalancing between parallel funds or "season and sell" transactions.

In addition, the SEC clarifies that tender offers would not be captured by the definition if an investor is not faced with the decision between (i) selling all or a portion of its interest and (ii) converting or exchanging all or a portion of its interest. Generally, 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 (so that the investor is not required to either sell or convert/exchange its interest), the transaction would not meet the definition of an adviser-led secondary transaction.

36 In addition, the SEC chose not to enact the proposed requirement of a written agreement with the auditor, pursuant to which the auditor is required to notify the SEC upon the auditor's termination or issuance of a modified opinion.
37 Rule 206(4)-10(b).
38 Rule 211(h)(2)-2.
39 Under Rule 211(h)(1)-1, "fairness opinion" means 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" and "valuation opinion" means a 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.
40 Under Rule 211(h)(1)-1, "independent opinion provider" is defined to mean a person that (i) provides fairness opinions or valuation opinions in the ordinary course of its business and (ii) is not a related person of the adviser.
41 Rule 211(h)(1)-1.

VI. Preferential Treatment Rule– Rule 211(h)(2)-3

The new Preferential Treatment Rule[42] prohibits all private fund advisers (RIAs and ERAs alike) from providing preferential treatment with respect to redemption rights or access to information that they reasonably expect would have a material, negative effect on other investors (with some limited exceptions). In other cases, advisers may provide preferential treatment if they disclose it to potential and actual investors.

The SEC adopted this rule, in part, to prevent two categories of preferential treatment that it views as contrary to the public interest and, in other cases, to allow for greater information rights and transparency for investors. The SEC views the provision of preferential treatment as a conflict of interest, given the incentives to provide preferential treatment to larger investors or other strategic partners in private funds that might otherwise harm smaller investors.

Prohibitions on Preferential Treatment

The adviser may not, directly or indirectly, do the following with respect to a private fund or any fund investor:[43]

- grant an investor in the 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 the private fund or in a similar pool of assets, except:
    - — if such ability to redeem is required by applicable laws, rules, regulations, or orders of any relevant foreign or U.S. government, state or political subdivision to which the investor, private fund or similar pool of assets is subject; or
    - — 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; or
- provide information regarding the portfolio holdings or exposures of the private fund, or of 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, except if the adviser offers such information in the private fund and any similar pool of assets at the same time or substantially the same time.

The flat prohibition on granting preferential redemption treatment is likely to impact open-ended funds in particular (such as hedge funds or evergreen funds), given that most closed-end funds do not typically allow redemption or withdrawal rights except in very limited circumstances (such as for regulatory reasons). The SEC has adopted these prohibitions because they view such preferential treatment as having the potential to unfairly harm private funds and their investors (including pension plans, educational endowments and non-profit organizations, among others) and therefore as contrary to the public interest.

As with the restricted activities requiring investor consent, the prohibitions will not apply to any 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, if the rule would require the parties to amend such governing agreements.[44]

Disclosure Requirements on Non-Prohibited Preferential Treatment

In addition to the outright prohibitions, the new Preferential Treatment Rule includes the following disclosure-based requirements that apply where an adviser to a private fund, directly or indirectly, provides any preferential treatment – such as through side letters or other side arrangements[45] – to any investor in the private fund unless the adviser provides written notices as follows:[46]

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42 Rule 211(h)(2)-3.
43 Rule 211(h)(2)-3(a).
44 Rule 211(h)(2)-3(d).
45 Side letters typically provide more favorable rights and privileges to certain preferred investors, such as anchor or strategic investors or investors with large commitments. In many cases, side letter provisions are designed to address an investor's special tax, regulatory, accounting, legal or other needs (such as ERISA, BHC, FOIA or non-US requirements).
46 Rule 211(h)(2)-3(b).

- *To each prospective investor in the private fund:* prior to the investor's investment in the private fund, written notice that provides specific information regarding any preferential treatment related to any material economic terms that the adviser or its related persons provide to other investors in the same fund;
- *To each current investor for an illiquid fund:* as soon as reasonably practicable following the end of the private fund's fundraising period, written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund;
- *To each current investor for a liquid fund:* as soon as reasonably practicable following the investor's investment in the private fund, written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund; and
- On at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided in accordance with this section, if any.

In a change from the proposal, the final rule limits the disclosure to prospective investors solely to material economic terms, thereby limiting the disclosure to the items most relevant to prospective investors and protecting the identity of investors with particularly bespoke tax, regulatory or legal side letter provisions.

VII. Applicability to offshore RIAs and ERAs

In the adopting release, the SEC states that it will maintain its historical position that most of the substantive provisions of the Advisers Act do not apply to the non-U.S. clients (including non-U.S. private funds) of an SEC-registered offshore adviser or offshore ERA, regardless of whether such offshore private funds have any U.S. investors.[47] Accordingly, the SEC will not expect offshore RIAs or ERAs to comply with any of the new rules with regard to their offshore private funds, but the new rules will apply to private funds of offshore RIAs and ERAs that are formed in the United States. Since certain institutional investor groups were vocal supporters of the proposed rules, some institutional investors nonetheless may expect compliance with some or all of the new rules regardless of the jurisdiction of formation of the private funds in which they propose to invest.

VIII. Compliance Rule

In addition to the five major reforms described above, the SEC adopted as proposed amendments to the Advisers Act rule requiring all SEC-registered advisers to document the annual review of the adequacy of their compliance policies and procedures in writing.[48] This amended rule, unlike the new rules discussed above, will take effect within 60 days of publication in the Federal Register.

IX. Recordkeeping Rule

In conjunction with the reforms described above, the SEC has amended Rule 204-2 (the "Books and Records Rule") under the Advisers Act to incorporate recordkeeping related to the five new major rules. While the Books and Records Rule applies only to RIAs, ERAs should be mindful of the recordkeeping standards, both as a 'best practices' approach and in the event that an ERA might one day be required to register with the SEC.

The amended rule expands the recordkeeping requirement to encompass the following:

- Quarterly Statements Rule: (i) copies of quarterly statements distributed to investors, each addressee and the date such statement was sent; (ii) records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers and performance listed on any quarterly statement; and (iii) records substantiating the adviser's determination that a private fund client is a liquid fund or an illiquid fund;[49]
- Audit Rule: (i) a copy of any audited financial statements, along with a record of each addressee and the corresponding date(s) sent; and (ii) records documenting the steps taken by the adviser to cause a private

47 In the adopting release, the staff takes pain to state that this position is a statement only of the staff and not of the Commission itself, and does not have the force of a rule or regulation.
48 Rule 206(4)-7(b).
49 Rule 204-2(a)(20)(i)-(ii) and (22).

fund client with which it is not in a control relationship to undergo a financial statement audit that complies with the rule;[50]

- Adviser-Led Secondaries Rule: a copy of the fairness opinion or valuation opinion, as well as the material business relationship summary distributed to investors and a record of each addressee and the date(s) the opinion and summary were sent;[51]
- Restricted Activities Rule: a copy of any notification, consent or other document distributed or received pursuant to the Restricted Activities Rule, along with a record of each addressee and the date(s) sent for each document distributed by the adviser;[52] and
- Preferential Treatment Rule: a copy of any notice required pursuant to the Preferential Treatment Rule, along with a record of each addressee and the corresponding date(s) sent.[53]

X. Effective Date

The new rules will take effect in a staggered manner of up to 18 months after the final rule is published in the Federal Register, depending on the rule and the amount of assets under management of the relevant adviser:[54]

- The Quarterly Statement Rule and Audit Rule will take effect 18 months after publication in the Federal Register;
- The Adviser-Led Secondaries Rule, Restricted Activities Rule and Preferential Treatment Rule will take effect:
  - — for advisers with less than $1.5 billion in private fund assets under management, 18 months after publication in the Federal Register; and
  - — for advisers with $1.5 billion or more in private fund assets under management, 12 months after publication in the Federal Register; and
- Revisions to the annual compliance review requirements will take effect within 60 days of publication in the Federal Register.

Legacy fund applicability (grandfathering). As described above, certain funds that have commenced operations prior to the effective date otherwise subject to the prohibition of the Preferential Treatment Rule and consent-based requirements of the Restricted Activities Rule will be "grandfathered" as legacy funds to the extent compliance would require the adviser and investors to amend the fund's governing documents.

Conclusion

The private fund reforms adopted represent the first major regulatory action for private funds under SEC chair Gary Gensler. Though not as bold as the original proposal, the new rules will provide greater transparency and disclosure for all private fund investors and increase compliance obligations and costs.

Remaining proposed rules include those on (i) cybersecurity practices, (ii) a new framework for disclosures on environmental, social and governance (ESG) standards, (iii) additional changes to Form PF proposed jointly with the U.S. Commodity Futures Trading Commission (in addition to the changes the SEC adopted in May 2023 to revise Form PF), (iv) a new 'Outsourcing Rule' designed to provide diligence to investors on a firm's third-party service providers, (v) broadening the custody rule into a new 'Safeguarding Rule' (though, as noted above, the comment period has been reopened in light of adoption of the Audit Rule) and (vi) a rule introduced last month designed to provide additional protections around the use of certain technologies, including AI. In addition,

50 Rule 204-2(a)(21)(i)-(ii).
51 Rule 204-2(a)(23).
52 Rule 204-2(a)(24).
53 Rule 204-2(a)(7)(v).
54 As of the date of publication, the rule has not yet been published in the Federal Register so the effective compliance dates will be no sooner than Q3 2024 (for the 12-month threshold) or Q1 2025 (for the 18-month threshold), respectively.

the SEC is ramping up examination for RIA compliance of the new Marketing Rule, which took full effect in November 2022.

We continue to monitor ongoing SEC rulemaking and other regulatory developments, and we will provide updates as additional proposals emerge and/or the SEC adopts final rules regarding the safeguarding rule and other proposals.

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