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SEC ADOPTS SIGNIFICANT NEW RULES FOR ADVISERS AND PRIVATE FUNDS

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I. EXECUTIVE SUMMARY

On August 23, 2023, the Securities and Exchange Commission (the "**SEC**") adopted controversial new rules[1] and amendments under the Investment Advisers Act of 1940 (as amended, the "**Advisers Act**") that will substantially alter the reporting, disclosure, recordkeeping, and other obligations of investment advisers to private funds (the "**Final Rules**").[2] Adopted over two Commissioners' dissenting votes, the Final Rules, in the SEC's view, serve a "compelling need" by addressing "significant risks and harms on investors and private funds."[3] In contrast, Commissioner Peirce, one of the two dissenting votes, believes the Final Rules are unnecessary: "The Commission struggles mightily to paint a picture of a failed market desperately in need of a prescriptive regulatory solution."[4]

In response to the many objections raised by commenters,[5] the Final Rules are marginally less onerous than the rules that were originally proposed by the SEC in early 2022.[6] The Final Rules apply entirely to investment advisers registered with the SEC ("**RIAs**") and partly to exempt reporting advisers, state-registered advisers, and other advisers not registered with the SEC (collectively, "**non-RIAs**" and together with RIAs, "**Advisers**"):

Requirement	Synopsis	RIAs	Non-RIAs
QUARTERLY STATEMENTS	Requires providing private fund investors with quarterly reports that set forth detailed information regarding private fund performance, fees, and expenses	X	
MANDATORY AUDITS	Requires obtaining an annual audit for each private fund an RIA advises and providing it to each investor	X	

[1] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 6383 (Aug. 23, 2023), [hereinafter *Final Rules*] available here.

[2] A "private fund" is an issuer of securities (e.g., limited partnership interests) that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act. *See* Form ADV, Glossary of Terms, at 34, available here.

[3] *Final Rules*, at 7.

[4] Hester M. Peirce, *Dissenting Statement of Commissioner Hester M. Peirce Concerning Adoption of the Final Rules*, SEC (Aug. 23, 2023), https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023#.

[5] *See, e.g.,* Haynes and Boone, LLP, Comment Letter on Proposed Rules Applicable to Private Fund Advisers (Apr. 25, 2022), available here ("**Haynes and Boone Comment Letter**"); Comment Letter of National Association of Private Fund Managers (Apr. 25, 2022), available here; Comment Letter of Citadel (May 3, 2022), available here. The SEC cited the Haynes and Boone Comment Letter twelve times in the Final Rules release, sometimes in connection with changes from the proposed rules. *See Final Rules*, at 282–84 nn.845, 849.

[6] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16886 (Mar. 24, 2022), [hereinafter *Proposed* Rules] available here; *see also* Evan K. Hall & Madelyn Calabrese, *SEC Proposes New Private Fund Adviser Rules* (Feb. 25, 2022), available here.

Requirement	Synopsis	RIAs	Non-RIAs
Adviser- Led Secondary Transactions	Requires providing private fund investors with fairness or valuation opinions and satisfying other requirements in connection with adviser-led secondary transactions	X	
Compliance Rule Documentation	Requires RIAs (including non-private fund advisers) to document in writing their annual compliance reviews pursuant to Rule 206(4)-7 under the Advisers Act	X	
Restricted Activities	Prohibits engaging in certain activities and practices with respect to their private funds unless certain disclosure (compliance expenses, clawback reductions, non-pro rata allocations) and/or consent (investigation expenses, borrowing) requirements are met	X	X
Preferential Treatment	Prohibits granting preferential treatment to private fund investors with respect to redemptions and portfolio information and other types of preferential treatment unless disclosed and/or consented to; and Requires disclosing all preferential treatment to existing, and in some cases, prospective investors.	X	X

A detailed overview of the Final Rules and their implications is set forth below.

II. Summary of the Final Rules

A. Rules Applicable to All Advisers

1. *Rule 211(h)(2)-1 – Restricted Activities*

a. Allowed with Consent

(1) Rule 211(h)(2)-1(a)(1) – Charging or Allocating Investigation Expenses

An Adviser is restricted from charging or allocating to any private fund fees or expenses associated with an investigation of the Adviser or its related persons by any governmental or regulatory authority, ***except*** with the advance written consent of at least a majority in interest of investors in the applicable private fund, excluding investors that are related persons of the Adviser.[7] Blanket consents in a private fund's governing documents will not satisfy the requirements, as investor consent must be obtained with respect to each specific investigation.[8]

Even with such consent, however, an Adviser may not charge or allocate such amounts to any private fund if the investigation results in a sanction of the Adviser or its related persons for a violation of the Advisers Act, and as a result, Advisers may be required to refund these amounts in cases where only minor, technical violations occur.[9]

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[7] *Final Rules*, at 236–42 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(a)(1)). The governing documents of a private fund can establish a higher threshold than a majority in interest.

[8] *Final Rules*, at 239 ("Such fees and expenses are related to the adviser's potential or actual wrongdoing and should be borne by the adviser unless investors consent in writing to paying them for **each specific investigation**." (emphasis added)).

[9] *Final Rules*, at 237 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(a)(1)).

(2) Rule 211(h)(2)-1(a)(5) – Borrowing

An Adviser may not, directly or indirectly, borrow money, securities, or other fund assets, or receive a loan or extension of credit from a private fund client without first disclosing the material terms of the transaction to investors and obtaining the written consent of a majority in interest of such fund's investors who are not related persons of the Adviser.[10] While the Final Rules do not list the specific terms to be disclosed, the SEC stated they "could include . . . the amount of money to be borrowed, the interest rate, and the repayment schedule, depending on the facts and circumstances."[11]

Borrowings from a third party on a private fund's behalf or borrowings from individual investors outside of the fund are not subject to this rule; only borrowings by the Adviser—directly or indirectly—from the private fund itself are covered.[12] The SEC also clarified in the Final Rules that ordinary tax advances and management fee offsets generally are not considered borrowings subject to these requirements.[13]

While Advisers rarely borrow from the private funds they advise, some typical fund mechanics not traditionally considered "borrowings" may nonetheless be considered "borrowings" within this rule's ambit. For example, satisfying an Adviser's commitment to the fund out of future amounts likely to be owed to the Adviser (e.g., from future performance compensation) is apparently subject to the disclosure and consent requirements in the rule.[14] Advisers should therefore give special consideration to any mechanics that affect the cash flows, or the timing thereof, between the Adviser on the one hand and the private fund on the other.

b. Allowed with Disclosure

(1) Rule 211(h)(2)-1(a)(2) – Charging or Allocating Compliance Expenses

To charge or allocate any regulatory or compliances fees or expenses (including those associated with an examination) to a private fund, Advisers must notify the private fund investors in writing of such fees or expenses and the amount thereof within 45 days of the end of the fiscal quarter in which such charge or allocation occurs.[15]

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[10] *Final Rules*, at 243–251 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(a)(5)).

[11] *Final Rules*, at 247.

[12] *See Final Rules*, at 247.

[13] *Final Rules*, at 249.

[14] *Final Rules*, at 248 ("However, we recognize that, in certain instances, such as in connection with enabling a smaller adviser to satisfy a sponsor commitment to the fund, investors may under certain terms be willing to accept a borrowing from the fund by the adviser.").

[15] *Final Rules*, at 212 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(a)(2)); *see also Final Rules*, at 212n.631 ("We are also reiterating that charging these expenses without authority in the governing documents is inconsistent with an adviser's fiduciary duty.").

(2) Rule 211(h)(2)-1(a)(3) – Reducing Adviser Clawbacks for Taxes

To reduce the amount of an Adviser clawback obligation by actual, potential, or hypothetical taxes applicable to the Adviser, such Adviser must distribute written notice to investors setting forth the aggregate dollar amounts of the adviser clawback before and after any such reduction within 45 days after the end of the fiscal quarter in which such clawback occurs.[16] RIAs may include the disclosure in the Quarterly Statement (discussed in Section II.B.1. below) if it is distributed within 45 days of fiscal quarter end, but there is no obligation to do so.[17]

(3) Rule 211(h)(2)-1(a)(4) – Non-Pro Rata Fee & Expense Allocations

An Adviser may not charge or allocate fees and expenses attributable to a portfolio investment (or a proposed portfolio investment) on a non-pro rata basis between when multiple private funds or other clients advised by the Adviser—or its related persons—participate in such portfolio investment, unless (i) it is fair and equitable under the circumstances; and (ii) prior to charging or allocating such amounts, the Adviser distributes to each private fund investor written notice of the non-pro rata charge or allocation and a description of how such non-pro rata charge or allocation is fair and equitable under the circumstances.[18]

In determining whether a particular allocation is fair and equitable, Advisers should consider, for example, whether an expense was incurred as a result of the specific type of security one client holds or a client's idiosyncratic structuring requirements or if one client receives a greater benefit from the expense relative to the other clients.[19] The SEC admits that due to the varied methods under which fees and expenses may be allocated or charged "pro rata," "some subjectivity" may be inherent in determining how to charge and allocate pro rata, and for non-pro rata charges and allocations, whether they are fair and equitable.[20] On the other end of the spectrum, allocating all broken deal expenses to the only client whose governing documents allow for broken deal expenses because all other clients in an unconsummated transaction do not allow for broken deal expenses generally would not be fair and equitable in the SEC's view.[21]

In the context of co-investments where fees and expenses are often allocated on a non-pro rata basis, the SEC expects that the rule's requirements can be met while co-investors review and

[16] *Final Rules*, at 218–24 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(a)(3)).
[17] *Final Rules*, at 223–24.
[18] *Final Rules*, at 225–26 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(a)(4)).
[19] *Final Rules*, at 231.
[20] *Final Rules*, at 236 ("We agree that there may be multiple methods to determine pro rata allocations, and we have therefore declined to define "pro rata." We recognize that the framework we are adopting could result in some subjectivity regarding how advisers calculate pro rata and when an allocation is fair and equitable.").
[21] *See Final Rules*, at 235.

negotiate the applicable documentation.[22] However, we expect this regulation will result in a more difficult co-investment process for Advisers.

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

Preferential liquidity or informational rights are prohibited—with some exceptions—if the Adviser reasonably expects the preferential rights to have a material, negative effect on other investors in the applicable private fund or in a similar pool of assets. According to the SEC, the "'reasonably expects standard' . . . imposes an objective standard that takes into account what the adviser reasonably expected at the time . . . based on the facts and circumstances."[23]

The newly defined term "**similar pool of assets**" is central to the analysis required under the preferential treatment rules, and the definition is worth quoting in full:

> "Similar pool of assets means a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940, a company that elects to be regulated as such, or a securitized asset fund) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons."[24]

Because of the "broad scope of the definition,"[25] Advisers must determine whether preferential liquidity or information rights are reasonably expected to have a material, negative effect not just on investors in the same private fund as the preferred investor, but also on all other investors in vehicles with substantially similar mandates. In clarifying the scope of the definition, the SEC states, "[D]epending on the facts and circumstances, . . . an adviser's healthcare-focused private fund may be considered a 'similar pool of assets' to the adviser's technology-focused private fund under the definition."[26] Yet, the SEC continues, "A pool of assets with a materially different target return or sector focus, for example, would likely not have substantially similar investment policies, objectives, or strategies to those of the subject private fund, depending on the facts and circumstances."[27]

Importantly, many types of asset pools fall within the scope of the definition, regardless of whether the pool is a private fund, even including Advisers' own proprietary vehicles.[28] While separately managed accounts are not within the scope of the definition, funds of one or any other pooled investment vehicles for a single investor are included.[29] Likewise, co-investment vehicles

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[22] *Final Rules*, at 234–35.
[23] *Final Rules*, at 271.
[24] *Final Rules*, at 651–52 (to be codified at 17 C.F.R. § 275.211(h)(1)-1) (emphasis added).
[25] *Final Rules*, at 286.
[26] *Final Rules*, at 286.
[27] *Final Rules*, at 287.
[28] *Final Rules*, at 287.
[29] *Final Rules*, at 289.

may be considered a similar pool of assets, depending on the facts and circumstances.[30] Consequently, Advisers must proceed with caution when multiple of its clients co-invest alongside one another, particularly when selectively disclosing information to only some of its clients.[31]

a. Rule 211(h)(2)-3(a)(1) – Preferential Redemptions

Advisers may not allow any investor in a private fund or a similar pool of assets to redeem its interests on terms that the Adviser reasonably expects to have a material, negative effect on other investors in such private fund or in a similar pool of assets, unless (i) such redemption rights are required by applicable law; or (ii) are offered to all existing and future investors in such private fund or similar pool of assets.[32] If the preferential redemption terms are granted to comply with applicable law under the first exception, the preferential treatment must still be disclosed to private fund investors under Rule 211(h)(2)-3(b) as discussed in Section II.A.2.c. below.[33]

For preferential liquidity rights to qualify under the second exception, such preferential rights must be offered and made available to all current and future investors without qualification—in other words, the rights cannot be conditioned on commitment size, investor's relation to the Adviser, or other factors.[34] However, the Final Rules suggest that different classes of interests in a private fund may allow for different liquidity rights so long as the other differing terms between the classes would not preclude some investors from selecting a class.[35] For example, the SEC suggests that granting quarterly liquidity to Class A interests subject to slightly higher management and performance fees but granting annual liquidity to Class B interests subject to slightly lower management and performance fees would be allowed under the rules (unless the Adviser had reason to believe that certain investors could not agree to the higher fees).[36] In contrast, offering Class A interests only to family and friends of the Adviser's employees facially violates the rule.

b. Rule 211(h)(2)-3(a)(2) – Preferential Transparency

Advisers may not provide information regarding the portfolio holdings or exposures of a private fund or a similar pool of assets to any investor in such private fund or a similar pool of assets if the Adviser reasonably expects the selective disclosure would have a material, negative effect on other investors in such private fund or similar pool of assets, unless the information is disclosed to all other existing investors in such private fund and any similar pool of assets at the same time

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[30] *Final Rules*, at 288–90.
[31] *See* Section II.A.2.b. *infra*.
[32] *Final Rules*, at 274–80 (to be codified at 17 C.F.R. § 275.211(h)(2)-3(a)(1)).
[33] *Final Rules*, at 277.
[34] *Final Rules*, at 279.
[35] *Final Rules*, at 279–80.
[36] *Final Rules*, at 279–80.

or substantially the same time.[37] The prohibition applies to all types of communications, whether written, verbal, visual, or otherwise.[38]

Notably, the SEC did not adopt an exception for information disclosed pursuant to applicable law, as is sometimes required by laws applicable to governmental or quasi-governmental investors. In the SEC's view, such an exception is not necessary "because advisers can now rely on the exception discussed above by offering to disclose information to all investors."[39]

In determining whether a material, negative effect to other investors would result, the liquidity rights of the investor receiving preferential information is crucial but not dispositive. In illiquid funds, the SEC "would generally not view preferential information rights . . . as having a material, negative effect,"[40] but under the required facts and circumstances analysis, Advisers must consider if "the preferred investor could front-run other investors in taking a (possibly synthetic) short position against the asset, driving its price down, and causing losses to other investors in the fund."[41] Moreover, the facts and circumstances analysis must be conducted across all similar pools of assets, as disclosing preferential information to investors in an Adviser's less-liquid fund may allow them to redeem their interests in the more-liquid fund, resulting in harm to the other investors in the less-liquid fund.[42]

If an Adviser determines the preferential disclosure is not reasonably likely to have a material, negative effect on other investors, then such Adviser need only comply with the preferential treatment disclosure obligations discussed in Section II.A.2.c. below. Most often, these obligations would require disclosing the preferred information at the end of the year, rather than at "substantially the same time."[43]

c. Rule 211(h)(2)-3(b) – Disclosure of All Preferential Treatment

For all preferential treatment granted to any private fund investor, Advisers are subject to additional disclosure obligations. For any preferential treatment related to "material economic" terms that the Adviser or its related persons provide to investors in a private fund, Advisers must distribute written notice to prospective investors of such fund, prior to their investment containing, "specific information" regarding the preferential economic terms.[44] To be "specific," the information in the notice cannot vaguely or generally state that some investors are subject to lower fee rates; rather, the notice should state the lower fee rate and the terms under which

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[37] *Final Rules*, at 280–85 (to be codified at 17 C.F.R. § 275.211(h)(2)-3(a)(2)).
[38] *Final Rules*, at 283n.850.
[39] *Final Rules*, at 284.
[40] *Final Rules*, at 285.
[41] *Final Rules*, at 265.
[42] *Final Rules*, at 265–66.
[43] *See Final Rules*, at 283; *see also Final Rules*, at 670 (to be codified at 17 C.F.R. § 275.211(h)(2)-3(b)(2)(iii)) (requiring annual written notice with specific information regarding "any preferential treatment provided by the adviser or its related persons to other investors in the same private fund").
[44] *Final Rules*, at 297 (to be codified at 17 C.F.R. § 275.204-2(a)(7)(v)).

the investor obtained the lower rate, such as a significantly higher commitment.[45] These notices to prospective investors must be retained in the books and records of Advisers.[46]

For any preferential treatment not relating to material economic terms,[47] the disclosure for illiquid funds must be made as soon as reasonably practicable following the end of the fundraising period, and for liquid funds, as soon as reasonably practicable following an investor's investment in the private fund.[48]

Finally, an Adviser must, at least annually, distribute written notice to all current investors with "specific information" regarding any preferential treatment afforded by the Adviser or its related persons to other investors in the same private fund since the last annual written notice.[49] If preferential terms have not been granted since the last notice—whether existing terms to new investors, new terms to existing investors, new terms to new investors, or existing terms to existing investors—the Final Rules state that no annual notice is required.[50]

3. Grandfathering of Legacy Provisions

With respect to private funds that have commenced operations as of the compliance date,[51] the restrictions on charging investigation expenses and on borrowing will not apply to contracts (e.g., limited partnership agreements, subscription credit facility agreements, subscription agreements, side letters, etc.) that were entered into in writing prior to the compliance date if the restricted activities rule would require the parties to amend such contract.[52] For example, the Final Rules do not require amending or removing side letter terms that granted preferential redemption or information rights to only a subset of a private fund's investors.[53]

In addition, the restrictions on preferential redemption and transparency rights will not apply to private funds that commence operations prior to the compliance date if the restrictions would require the governing documents of the fund to be amended.[54] Therefore, such preferential terms granted to an investor in writing before the compliance date will not require granting the same redemption rights to all other investors or disclosing information given to the preferred investor at substantially the same time as other investors. However, any such preferential

[45] *Final Rules*, at 297.

[46] *Final Rules*, at 300–01 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(b)(1)).

[47] *Final Rules*, at 298–300 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(b)(2)).

[48] *Final Rules*, at 298 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(b)(2)(i)–(ii)).

[49] *Final Rules*, at 298n.893 and accompanying text (to be codified at 17 C.F.R. § 275.211(h)(2)-1(b)(2)(iii)).

[50] *Final Rules*, at 298n.893.

[51] For Advisers with less than $1.5 billion in assets under management, the approximate compliance date is March 25, 2025. For Advisers with $1.5 billion or more in assets under management, the approximate compliance date is September 25, 2024. Compliance and effective dates are determined with respect to the date the Final Rules are published in the Federal Register. *See Final Rules* at 315. The Proposed Rules were originally released on February 9, 2022, and published in the Federal Register on March 24, 2022, suggesting approximately one month should be added to the dates provided in the Final Rules.

[52] *Final Rules*, at 657 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(b)); *see also Final Rules*, at 315–20.

[53] *Final Rules*, at 318–19.

[54] *Final Rules*, at 317 (to be codified at 17 C.F.R. § 275.211(h)(2)-3(d)).

redemption or transparency rights in existence must nonetheless be disclosed in accordance with the disclosure obligations detailed in Section II.A.2.c. above.[55]

However, legacy status will **not** be accorded to the portions of the restricted activities rule and the preferential treatment rule that require disclosure to investors (i.e., charging compliance expenses, reducing Adviser clawbacks for taxes, charging on a non-pro rata basis, and preferential redemption or transparency rights).[56] Consequently, information in currently existing side letters is required to be disclosed to other investors following the compliance date.[57]

Regardless of these legacy carve outs, fees and expenses relating to an investigation that found a violation of the Adviser's Act still may not be charged or allocated to a private fund in any event.[58]

B. Rules Applicable to Only RIAs

1. Rule 211(h)(1)-2 – Delivery of Quarterly Statements

Each RIA must distribute to private fund investors a quarterly statement ("**Quarterly Statement**") that includes: (i) a fund table; (ii) a portfolio investment table; and (iii) performance information.[59] The Quarterly Statement must use clear, concise, plain English and be formatted in a way that allows investors to compare Quarterly Statements.[60] RIAs must consolidate the Quarterly Statement for a private fund and its similar pools of assets if doing so "would provide more meaningful information to the private fund's investors and would not be misleading," for example in a master-feeder or parallel fund structure.[61] An investor may still negotiate for additional reporting, as the Quarterly Statement only sets a "baseline level of reporting,"[62] but any such additional reporting the RIA grants is ostensibly subject to the preferential transparency rule. Consequently, disclosure of such additional information to all other investors may be required as detailed in Section II.A.2.b.[63]

The fund table must include the information below, both before and after the application of any offsets, rebates, or waivers of all compensation, fees, and expenses:

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[55] *Final Rules*, at 317 ("As a result, information in side letters that existed before the compliance date will be disclosed to other investors . . . .").
[56] *Final Rules*, at 317–18.
[57] *Final Rules*, at 317.
[58] *Final Rules*, at 657 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(b)).
[59] *Final Rules*, at 60–161 (to be codified at 17 C.F.R. § 275.211(h)(1)-2).
[60] *Final Rules*, at 156–59 (to be codified at 17 C.F.R. § 275.211(h)(1)-2(g)).
[61] *Final Rules*, at 153–56 (to be codified at 17 C.F.R. § 275.211(h)(1)-2(f)).
[62] *Final Rules*, at 70.
[63] *See Final Rules*, at 280–90.

- a detailed accounting of all compensation, fees, and other amounts allocated or paid to the RIA or any of its related persons as separate line items (including any paid by a covered portfolio investment);
- 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 (e.g., tax, legal, travel); and
- the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments/allocations to the RIA.

The portfolio investment table requires investment-level reporting for any entity or issuer in which the private fund has directly or indirectly invested and has allocated or paid the RIA or its related persons compensation, fees, or other amounts, (each, a "**Covered Portfolio Investment**").[64] These disclosures are "designed to highlight the scope and magnitude of any investment-level compensation and to improve transparency for investors into the potential and actual conflicts of interest of the adviser and its related persons."[65] The portfolio investment table must include, both before and after the application of any offsets, rebates, or waivers of all compensation, fees, and expenses, a detailed accounting of all portfolio investment compensation allocated or paid to the RIA or any of its related persons by each Covered Portfolio Investment during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount.

The Quarterly Statement must also detail performance information, including: (i) the specified metrics in the table below; (ii) the applicable calculation methodology; and (iii) cross-references to the private fund's organizational and offering documents setting forth the calculation methodology.[66] "Similarly, if an adviser is knowingly using off-market assumptions (such as highly irregular valuation practices that are not used by similarly-situated advisers) when calculating performance without disclosing such to investors, we would view that practice as deceptive."[67]

Illiquid funds are newly defined as private funds that (i) are not required to redeem interests upon an investor's request; and (ii) have limited opportunities, if any, for investors to withdraw

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[64] *See Final Rules*, at 91–102; *see also Final Rules*, definitions of (i) "portfolio investment" ("any entity or issuer in which the private fund has directly or indirectly invested"); (ii) "covered portfolio investment" ("a portfolio investment that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period"); and (iii) "portfolio investment compensation" ("any compensation, fees, and other amounts allocated or paid to the investment adviser or any of 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, directors, trustees or similar fees or payments").

[65] *Final Rules*, at 94.

[66] *Final Rules*, at 60–64 (to be codified at 17 C.F.R. § 275.211(h)(1)-2(e)).

[67] *Final Rules*, at 64.

before termination of the fund. Liquid funds are all other private funds. The performance information required in the Quarterly Statement differs according to these categories:

Liquid Funds	**Illiquid Funds**
• *Annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever time period is shorter;* • *Average annual net total returns over the one-, five-, and 10-fiscal-year periods; and* • *The cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the Quarterly Statement.*	• *The following metrics, since inception through the end of the quarter covered by the Quarterly Statement, computed with and without the impact of any fund-level subscription facilities:* ◦ *fund level Gross IRR and gross MOIC;* ◦ *fund level Net IRR and net MOIC; and* ◦ *realized and unrealized Gross IRR and gross MOIC shown separately.* • *A statement of contributions and distributions.*

RIAs must deliver the quarterly statement for a private fund utilizing a non-fund-of-fund strategy within 45 days of the end of the first three fiscal quarters and within 90 days of the last fiscal quarter; for a private fund that does utilize a fund-of-funds strategy, these deadlines are extended to 75 days and 120 days, respectively.[68]

2. Rule 206(4)-10 – Mandatory Audits

Under the Final Rules, all RIAs must obtain a financial statement audit of each private fund by an independent public accountant registered with the Public Company Accounting Oversight Board and subject to its regular inspection.[69] The audited financial statements must be prepared in accordance with generally accepted accounting principles and delivered annually, together with the financial statement's related notes, schedules, and audit opinion, to investors within 120 days of the private fund's fiscal year-end and promptly upon liquidation.[70] A surprise examination pursuant to Rule 206(4)-2 under the Advisers Act does not satisfy the requirements of this mandatory audit rule with respect to any private fund advised by an RIA,[71] and as a result, the surprise examination option under the custody rule is "effectively eliminate[d]."[72]

With respect to special purpose vehicles in a private fund complex, separate audits are required if the RIA treats such vehicle as a separate client it advises directly. In contrast, if the RIA treats the assets of such vehicle as assets of the applicable private fund it advises, and therefore advises the vehicle only indirectly, then a separate audit is not required.[73]

[68] *Final Rules*, at 64 (to be codified at 17 C.F.R. § 275.211(h)(1)-2(a)).
[69] *Final Rules*, at 163–64 (to be codified at 17 C.F.R. § 275.206(4)-10(a) (incorporating certain requirements of the Custody Rule by reference to 17 C.F.R. § 275.206(4)-2(b)(4)(i)–(iii))).
[70] *Final Rules*, at 164, 166 (to be codified at 17 C.F.R. § 275.206(4)-10(a) (incorporating certain requirements of the Custody Rule by reference to 17 C.F.R. § 275.206(4)-2(b)(4)(i)–(iii))).
[71] *Final Rules*, at 164.
[72] *Final Rules*, at 166.
[73] *Final Rules*, at 173.

If an RIA does not control a private fund it advises, nor is under common control with such fund's adviser—for example, if the RIA is a sub-adviser to the private fund—then the RIA is only required to take all reasonable steps to cause the fund to meet the requirements of the rule (e.g., including the requirement in applicable governing agreements); otherwise, the RIA is prohibited from providing investment advice, directly or indirectly, to the private fund.[74]

3. Rule 211(h)(2)-2 – Adviser-Led Secondary Transactions

The Final Rules require certain procedures with respect to any "**Adviser-Led Secondary**," defined as any transaction initiated by an RIA 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 RIA or any of its related persons.[75] For any Adviser-Led Secondary, RIAs must obtain and distribute to investors in the applicable fund prior to the due date of the binding election form a fairness opinion or a valuation opinion regarding the transaction, as well as a written summary of the material business relationships the RIA or its related persons have had with the opinion provider in the two years immediately prior to the issuance of such opinion.[76]

4. Amended Rule 206(4)-7 – Compliance Rule Documentation

At least annually, all RIAs (including non-private fund advisers) must document in writing the required annual review of their compliance policies and procedures.[77] The annual compliance review requires RIAs to review the adequacy of their compliance policies and procedures and the effectiveness of their implementation, taking into consideration any compliance matters from the prior year, changes to the RIA's business activities, and changes to applicable law.[78] The Final Rules do not list items required to be documented or specify a format of the annual review but instead allow RIAs to determine how the review should be conducted and documented.[79]

C. Unadopted Rules

1. Fees for Unperformed Services

While not formally adopted in the Final Rules, the Proposed Rules would have prohibited 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

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[74] *Final Rules*, at 164–65 (to be codified at 17 C.F.R. § 275.206(4)-10(b)).
[75] *Final Rules*, at 186 (to be codified at 17 C.F.R. § 275.211(h)(1)-1).
[76] *Final Rules*, at 186–87 (to be codified at 17 C.F.R. § 275.211(h)(2)-2).
[77] *Final Rules*, at 302–08 (to be codified at 17 C.F.R. § 275.206(4)-7); *see also* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 38 Fed. Reg. 74,714 (proposed Dec. 17, 2003).
[78] *Final Rules*, at 302.
[79] *Final Rules*, at 306–07.

investment. Rather than adopting the proposal, the SEC states in the Final Rules that the prohibition is unnecessary because such a practice is already prohibited as a violation of the Adviser's fiduciary duties, as doing so often "involves a misrepresentation or an omission of a material fact"[80] and is tantamount to the Adviser placing its own interests ahead of its client's interests.[81]

2. Standard of Liability

The Proposed Rules, if adopted, would have prohibited an Adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund, thereby altering the market standard of liability, "gross negligence." While not formally adopted in the Final Rules, the SEC stated its view that "a breach of the Federal fiduciary duty may involve conduct that is intentional, reckless, or negligent,"[82] and an Adviser may not waive "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."[83] Consequently, Advisers may not purport to waive "any and all liability" or their Federal fiduciary duty.[84] For such breaches, an Adviser already may not seek reimbursement, indemnification, or exculpation because it would operate as a waiver of the unwaivable Federal fiduciary duty. By implication, however, the SEC blessed the use of "savings clauses" commonly used in indemnification and exculpation clauses. These clauses generally state that notwithstanding any general waiver language in fund documents, an investor may retain non-waivable rights under applicable law.[85]

D. Applicability to Securitized Asset Funds and Offshore Advisers

1. Securitized Asset Funds

With respect to the securitized asset funds they advise, Advisers are only subject to the portion of the Final Rules requiring written documentation of the annual compliance review. Securitized asset funds are defined as "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders."[86] To qualify as a securitized asset fund, the nomenclature applied to an investor is inconsequential; rather, how a group of investors is treated is key: a "debt investor" cannot be treated like an "equity investor."[87] It is

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[80] *Final Rules*, at 253.
[81] Final Rules, at 254.
[82] *Final Rules*, at 260.
[83] *Final Rules*, at 258; *see also id.* at 260n.782 (explaining that only a showing of ***simple*** negligence is needed under Section 206(2) of the Advisers Act, which prohibits "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6(2).).
[84] *Final Rules*, at 260.
[85] *Final Rules*, at 260n.781
[86] *Final Rules*, at 53–54 (to be codified at 17 C.F.R. § 275.211(h)(1)-1).
[87] *Final Rules*, at 54n.156.

unlikely that any hedge fund, private equity fund, or credit fund would qualify, and it is doubtful that the more recent collateralized fund obligation structures ("**CFOs**") meet the definition. The SEC believes that "debt investors" in CFOs are in fact equity investors because debt investors are treated the same as equity investors, have no right to repayment following a default, and the rated notes they hold are not asset-backed securities.[88] In contrast, a securitized asset fund issues "tradeable, interest-bearing debt securities backed by income-producing assets, unlike other private funds that typically issue equity securities to investors."[89]

2. Applicability to Offshore Advisers

The SEC confirmed in the adopting release that (i) none of the Final Rules apply with respect to the non-U.S. fund clients of an offshore RIA (regardless of whether such funds have U.S. investors);[90] and (ii) the restricted activities rule and the preferential treatment rule do not apply to the non-U.S. fund clients of unregistered offshore advisers (regardless of whether such funds have U.S. investors).[91] As a result, offshore RIAs will only be subject to the Final Rules with respect to their U.S. private fund clients, and offshore unregistered advisers will only be subject to the preferential treatment rule and the restricted activities rule with respect to their U.S. private fund clients.

III. CONCLUSION

The Final Rules impose sweeping changes to Advisers' practices, particularly with respect to the terms offered only to some investors in an Adviser's line of products. Advisers should begin to consider how to implement the significant changes to negotiation and investor relation procedures to comply with the Final Rules' requirements.

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For more information, or if you have any questions, please contact one of the following Haynes and Boone attorneys:

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[88] *Final Rules*, at 54n.156.

[89] Final Rules, at 58.

[90] *Final Rules*, at 49 ("The Commission's historical approach applies such that none of the final rules or amendments apply with respect to the offshore fund clients of an SEC-registered offshore adviser.").

[91] *Final Rules*, at 48 ("We agree with commenters and clarify that the restricted activities rule and the preferential treatment rule do not apply to offshore unregistered advisers with respect to their offshore funds (regardless of whether the funds have U.S. investors).").