MORRISON FOERSTER

For information on MoFo's Investment Management Practice, see here.
For information on MoFo's Private Funds Practice, see here.

Our responses below are general in nature and based solely on the information contained in SEC Release No. IA-6383 (the "Release"). They are intended to provide investment advisers and other professionals with a brief overview of the information contained in the Release and should not be relied upon in place of seeking legal counsel. We note that the new rules (the "New Rules") under the Investment Advisers Act of 1940 (the "Advisers Act") remain subject to challenge and certain aspects of the New Rules require further clarification. Industry practice will undoubtedly evolve as the New Rules are clarified, further interpreted, and implemented.

We will continue to update these FAQs as additional guidance is released by the SEC.

Last Updated: August 31, 2023

Contents

A) COMPLIANCE 1

1. What is the timeline for compliance? 1

2. What rules allow "legacy" treatment of existing agreements and to what extent? 1

3. Do the New Rules apply to non-U.S. Private Funds? 2

4. How much is coming into compliance going to cost and what is compliance on a going-forward basis expected to cost? 2

B) QUARTERLY STATEMENT RULE – RULE 211(h)(1)-2 2

1. Who does the quarterly statement rule apply to? 2

2. Quarterly Statement Content Requirements 2

a. Adviser Compensation Table. What types of adviser compensation must be disclosed in a quarterly report? Can an adviser exclude any types of compensation from the quarterly report? . 2

b. Adviser Compensation Table. Can an adviser create general groups of expenses or label certain expenses as miscellaneous for purposes of this disclosure? 3

c. Adviser Compensation Table. Who is considered a "related person" of an adviser for purposes of this disclosure? 3

d. Fund Fees and Expenses Table. What types of fees and expenses must be disclosed in a quarterly report? Can an adviser exclude any types of fund fees and expenses from the quarterly report? 3

e. Fund Fees and Expenses Table. Can an adviser group expenses for purposes of this disclosure? 3

f. Fund Fees and Expenses Table. Should an adviser disclose an expense in the fund table twice if it can be characterized as adviser compensation and a fund expense? 4

g. Portfolio Investment-Level Table. What types of portfolio investment information must be disclosed in the quarterly report? 4

h. Portfolio Investment-Level Table. How should an adviser reflect broken deal expenses in the quarterly statement? 4

i. Portfolio Investment-Level Table. How should an adviser to a fund-of-funds determine whether it has received compensation from an entity that is a portfolio investment of an underlying fund that is advised by an unaffiliated adviser? 4

j. Portfolio Investment-Level Table. How should an adviser disclose portfolio investment compensation paid to the private fund adviser and another party, such as co-investor? 5

k. Portfolio Investment-Level Table. Should an adviser disclose the names of the portfolio investments as part of the portfolio investment compensation disclosure? 5

l. General. How should an adviser disclose any offsets, rebates, or waivers in the adviser compensation, fund fees, and portfolio investment compensation tables? 5

m. Performance. Do the Rule's performance reporting requirements differ based on the type of private fund? 6

n. How should an adviser determine whether a private fund client is a liquid or illiquid fund? 6

o. Performance. For purposes of performance reporting for illiquid funds, how should an adviser factor in any fund-level subscription facilities? 6

p. Performance. For purposes of performance reporting, should an adviser include gross and/or net figures? 6

q. Performance. For purposes of performance reporting for illiquid funds, how should an adviser determine whether an investment is realized or unrealized? 7

r. Performance. What other information must an adviser disclose in connection with the required performance figures? 7

3. Quarterly Statement Delivery and Distribution. 7

a. When must an adviser deliver quarterly statements to the private fund investors? 7

b. How must advisers distribute quarterly statements to private fund investors? 7

c. Can an adviser provide the quarterly statement information through a data room? 7

d. How does an adviser satisfy the Rule's delivery requirement for an investor that is itself a pooled investment vehicle? 8

4. If a registered investment adviser sub-advises a private fund and the fund's primary adviser is not subject to the quarterly statement rule, will the rule still apply to the sub-adviser? 8

5. Can an adviser include information in a quarterly statement in addition to what is required under the Rule? 8

6. Does the quarterly statement rule impose any formatting requirements for the quarterly statements? 8

7. Does the quarterly statement rule contemplate consolidated reporting for multiple funds advised by an adviser? 9

8. What records must an adviser maintain in connection with the quarterly statement rule? 9

C) MANDATORY AUDIT RULE – RULE 206(4)-10 9

1. Who does the mandatory audit rule apply to? 9

2. How does the audit rule interact with the Advisers Act custody rule (Rule 206(4)-2)? 9

3. What are the delivery requirements for the financial statement audits required by the audit rule? 10

4. Does the audit rule require that the financial statement audits are prepared in accordance with U.S. generally accepted accounting principles (GAAP)? 10

5. How will the audit rule apply to an investment adviser that advises a private fund, but does not "control" the fund or is not under common control with the fund (e.g., an unaffiliated investment adviser sub-advises the fund)? 10

6. If an adviser to a private fund utilizes one or more special purpose vehicles (SPV) to facilitate the private fund's investments for legal, tax, regulatory or similar purposes, will the audit rule require that the adviser obtain a separate financial statement audit for that SPV? 10

7. If an investment adviser is located offshore and advises an offshore fund, can it satisfy the audit rule by obtaining a financial statement audit by an accountant that is overseen by a regulator in the local jurisdiction, rather than the PCAOB? 11

8. Does the audit rule require that an adviser obtain a financial statement audit upon liquidation of a private fund it advises? 11

D) ADVISER-LED SECONDARIES RULE (Rule 211(h)(2)-2) 11

1. Who does the adviser-led secondaries rule apply to? 11

2. What is considered an "adviser-led secondary transaction"? 11

3. Who is considered a "related person" of an adviser? 12

4. What are the requirements of the adviser-led secondaries rule? 12

5. Does the opinion need to cover anything other than price/ valuation? 13

6. How early can the opinion be dated? When does the opinion become stale? 13

7. What needs to be covered by the summary of material business relationships? 13

8. What records related to the opinion and summary of material business relationships need to be kept? 13

9. What should parties consider when negotiating governing documents going forward? 13

E) RESTRICTED ACTIVITIES RULE (Rule 211(h)(2)-1) 14

1. Who does the restricted activities rule apply to? 14

2. The restricted activities rule includes certain disclosure and, in some cases, consent exceptions. Which exceptions apply to which activities? 14

3. Is disclosure to, or consent by, an Advisory Committee sufficient? 14

4. Do advisers need to look through investors that are pooled investment vehicles for purposes of applying the disclosure or consent exceptions? 15

5. What is the required consent threshold? Can this threshold be altered by agreement? 15

6. What does disclosure entail? Does disclosure in the PPM and consent via a governing agreement suffice? Can the required disclosure be combined with other reports? 15

7. What records related to disclosure and consent should be maintained? 15

8. Rule 275.211(h)(2)-1(a)(1): Investigation Expenses 16

- **a. Investigation Expenses: What expenses are captured by the rule?** 16
- **b. Investigation Expenses: The rule requires prior consent by at least a majority in interest of a fund's investors. Does a general consent, such as in the governing documents of a private fund suffice?** 16
- **c. Are estimates ok? What if the investigation results in a sanction after certain fees have already been charged to a fund?** 17
- **d. What if investors do not respond? Could a deemed consent clause apply?** 17
- **e. Investigation Expenses: What should parties consider when negotiating governing documents going forward?** 17

9. Rule 275.211(h)(2)-1(a)(2): Regulatory, Compliance and Examination Expenses 17

- **a. Regulatory, Compliance and Examination Expenses: What expenses are captured by the rule?** 17
- **b. Regulatory, Compliance and Examination Expenses: What if an examination results in deficiencies or findings? Would that be considered a "sanction" such that the related expenses cannot be charged to a private fund?** 18
- **c. Regulatory, Compliance and Examination Expenses: What information must be disclosed?** 18
- **d. Regulatory, Compliance and Examination Expenses: What should parties consider when negotiating governing documents going forward?** 19

10. Rule 275.211(h)(2)-1(a)(3): Reducing Adviser Clawbacks for Taxes 19

- **a. Reducing Adviser Clawbacks for Taxes: Does this mean advisers are now required to include a clawback mechanism in the governing documents of the private funds they advise?** 19
- **b. Reducing Adviser Clawbacks for Taxes: What exactly must be disclosed?** 20
- **c. Reducing Adviser Clawbacks for Taxes: What should parties consider when negotiating governing documents going forward?** 20

11. Rule 275.211(h)(2)-1(a)(4): Non-Pro Rata Fee and Expense Allocations 20

- **a. Non-Pro Rata Fee and Expense Allocations: What fees and expenses are captured by the rule?** 20

b. Non-Pro Rata Fee and Expense Allocations: How is pro rata defined by the SEC? 21

c. Non-Pro Rata Fee and Expense Allocations: What are the requirements of the exception? 21

d. Non-Pro Rata Fee and Expense Allocations: What information should be included in the notice? 21

e. Non-Pro Rata Fee and Expense Allocations: How much in advance does the notice need to be distributed? 21

f. Non-Pro Rata Fee and Expense Allocations: Does a general disclosure of an expense allocation policy and related procedures (for example in a PPM or as part of a diligence package circulated during the fundraising process) suffice? 22

g. Non-Pro Rata Fee and Expense Allocations: How does this rule apply to co-investments and costs related to unconsummated investments? 22

12. Rule 275.211(h)(2)-1(a)(5): Borrowing from a Private Fund Client 22

a. Borrowing from a Private Fund Client: What does "borrowing" include? 22

b. Borrowing from a Private Fund Client: Are borrowings from fund investors captured by this rule? 23

c. Borrowing from a Private Fund Client: What must be disclosed in the solicitation for consent? 23

d. Borrowing from a Private Fund Client: What should parties consider when negotiating governing documents going forward? 23

F) PREFERENTIAL TREATMENT RULE (Rule 211(h)(2)-3) 23

1. Who does the preferential treatment rule apply to? 23

2. Who is considered a "related person" of an adviser for purposes of the preferential treatment rule? 23

3. The preferential treatment rule includes several exceptions. Which exceptions apply to which activities? 24

4. The prohibition against redemption rights and information rights regarding portfolio holdings excludes rights offered to all other investors requires "in a similar pool of assets." 24

a. Similar pool of assets. What if preferential treatment is given to an investor in a parallel fund? Does the right need to be offered to all investors in the main fund? 24

b. Similar pool of assets. When will a pool of assets be determined to be "similar" to a private fund? 25

c. Similar pool of assets. What about managed accounts or a fund-of-one? 25

d. Similar pool of assets. What about co-investment vehicles? 26

5. What if the preferential rights are offered to a subset of investors, such as those holding a different share class? 26

6. Do an investor's policies or resolutions count as "required by law" for purposes of the exemption to the prohibition against offering redemption rights? 26

7. How will the "reasonably expects" standard be applied? 26

8. Is there a materiality threshold? 27

9. What if the preferential treatment is not in writing? For example, information is disclosed in conversation to one investor. 27

10. When would preferential information rights not be reasonably expected to have a material, negative effect on other investors? 27

11. What are the disclosure requirements? How might this impact the fundraising process? 27

12. What are some examples of preferential treatment related to economic terms? Does that just capture fee and carry breaks? 28

13. What records related to the preferential rule need to be kept? 29

G) OTHER 29

1. What are other key takeaways from the Release that are not covered by the Rules themselves? 29

A) COMPLIANCE

1. What is the timeline for compliance?

The New Rules will be effective 60 days after the date of publication in the Federal Register. Once effective, investment advisers will need to come into compliance with the New Rules within the timeframes set forth below (measured from the date of publication in the Federal Register):

Rule	**Registered Advisers** *(including advisers required to be registered)*		**Unregistered Advisers** *(including exempt reporting advisers)*		Legacy Treatment**
	Advisers with ≥ $1.5B in AUM*	***Advisers with ≤ $1.5B in AUM****	***Advisers with ≥ $1.5B in AUM****	***Advisers with ≤ $1.5B in AUM****	
Quarterly Statement	18 months		N/A		No
Mandatory Audit	18 months		N/A		No
Adviser-Led Secondaries	12 months	18 months	N/A		No
Restricted Activities	12 months	18 months	12 months	18 months	Yes
Preferential Treatment	12 months	18 months	12 months	18 months	Yes
Compliance Rule *(as amended)*	60 days		N/A		No

* Refers to private funds assets under management.
** See "what rules allow "legacy" treatment of existing agreements and to what extent?" below.

Advisers should not underestimate the time or cost necessary to implement the requirements of the New Rules (see "How much is coming into compliance going to cost and what is compliance on a going-forward basis expected to cost?" below). The New Rules represent a significant shift in the amount and types of disclosure that will be required to be provided to investors in private funds. In some cases (e.g., the audit rule discussed below), private fund advisers may need to identify and negotiate contracts with new service providers. In short, advisers will need to significantly overhaul their compliance and operational procedures in a relatively short timeframe to ensure compliance with these new requirements.

2. What rules allow "legacy" treatment of existing agreements and to what extent?

Restricted Activities Rule: Advisers do not need to amend any of a private fund's written agreements that were entered into prior to the compliance date if the private fund "commenced operations" prior to the compliance date; *except, that,* investment advisers cannot charge a private fund, or allocate to a private fund, fees and 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. The disclosure aspects of the restricted activities rule will apply to all private funds on a going-forward basis, regardless of when they "commenced operations."

Preferential Treatment Rule: Advisers do not need to amend any of a private fund's written agreements entered prior to the compliance date if the private fund "commenced operations" prior to the compliance date. The disclosure aspects of the preferential treatment rule will apply to all private funds on a going-forward basis, regardless of when they "commenced operations." Legacy status does not apply to the disclosure portions of the preferential treatment rule. Side letters that existed before the compliance date will need to be disclosed to investors that invest in the fund post compliance date. Advisers can anonymize the information required to be disclosed.

"**Commencement of operations**" includes, for example, holding an initial fund closing, issuing capital calls, setting up a subscription facility for the fund, conducting due diligence on potential fund investments, or making an investment on behalf of the fund.

3. Do the New Rules apply to non-U.S. Private Funds?

The New Rules will generally not apply with respect to non-U.S. clients (including private funds) managed by an offshore investment adviser, regardless of whether that adviser is registered and whether any U.S. investors participate in the fund, consistent with the SEC's historical application of the Advisers Act.

4. How much is coming into compliance going to cost and what is compliance on a going-forward basis expected to cost?

The SEC considered the expected cost of compliance – both initially and on a going-forward basis – in voting to adopt the New Rules. The estimates used by the SEC are outlined in the Release. We are consulting with auditing and other advisors and service providers to offer a clearer sense of expected auditing, legal, reporting, and other compliance costs.

B) QUARTERLY STATEMENT RULE – RULE 211(h)(1)-2

1. Who does the quarterly statement rule apply to?

The quarterly statement rule will apply to all investment advisers registered, or required to be registered, with the SEC that advise a private fund (other than a securitized asset fund).

2. Quarterly Statement Content Requirements

a. Adviser Compensation Table. What types of adviser compensation must be disclosed in a quarterly report? Can an adviser exclude any types of compensation from the quarterly report?

The rule requires that the quarterly report capture all forms and amounts of compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the fund, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation. It does not allow the exclusion of any types of compensation, including *de minimis* expenses.

b. Adviser Compensation Table. Can an adviser create general groups of expenses or label certain expenses as miscellaneous for purposes of this disclosure?

No, the rule does not permit the quarterly statement to group smaller expenses into broad categories or label expenses as miscellaneous. All forms of adviser compensation must be disclosed as separate line items.

c. Adviser Compensation Table. Who is considered a "related person" of an adviser for purposes of this disclosure?

"Related persons" include: (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser. The definitions for "related persons" and "control" are the same as those used in Form ADV.

d. Fund Fees and Expenses Table. What types of fees and expenses must be disclosed in a quarterly report? Can an adviser exclude any types of fund fees and expenses from the quarterly report?

The rule requires the fund fees and expenses table to show a detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period, other than those disclosed as adviser compensation, with separate line items for each category of fee or expense reflecting the total dollar amount. The rule captures all fund fees and expenses allocated to or paid by the fund during the reporting period, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses.

e. Fund Fees and Expenses Table. Can an adviser group expenses for purposes of this disclosure?

No. Like the adviser compensation table, advisers must list each category of expense as a separate line item under the rule, rather than group fund expenses into broad categories that obfuscate the nature and/or extent of the fees and expenses borne by the fund. For example, if a fund paid insurance premiums, administrator expenses, and audit fees during the reporting period, a general reference to "fund expenses" on the quarterly statement will not satisfy the rule's detailed accounting requirement. Instead, an adviser must separately list each category of

expense (i.e., in the example above, insurance premiums, administrator expenses, and audit fees) and the corresponding total dollar amount.

f. **Fund Fees and Expenses Table. Should an adviser disclose an expense in the fund table twice if it can be characterized as adviser compensation and a fund expense?**

No. To the extent that a fund expense also could be characterized as adviser compensation under the rule, an adviser must disclose such payment or allocation as adviser compensation as opposed to a fund expense in the quarterly statement.

g. **Portfolio Investment-Level Table. What types of portfolio investment information must be disclosed in the quarterly report?**

The rule requires advisers to disclose a detailed accounting of all "portfolio investment compensation" allocated or paid by each covered portfolio investment during the reporting period in a single table. The table must include separate line items for each category of allocation or payment reflecting the total dollar amount, including, but not limited to, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees, or similar fees or payments by the covered portfolio investment to the investment adviser or any of its related persons. The rule broadly defines "portfolio investment" to include any entity or issuer in which the private fund has invested directly or indirectly. This definition captures any entity or issuer in which the private fund holds an investment, including through holding companies, subsidiaries, acquisition vehicles, SPVs, or other vehicles. The rule defines "covered portfolio investment" as a portfolio investment that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period.

h. **Portfolio Investment-Level Table. How should an adviser reflect broken deal expenses in the quarterly statement?**

Because the definition of "portfolio investment" under the rule includes only entities or issuers in which a private fund has invested (whether directly or indirectly), the rule's portfolio investment compensation requirements would not generally apply to compensation, such as a broken deal fee, from only a potential portfolio investment. A broken deal fee from an unconsummated portfolio investment transaction would thus generally not constitute portfolio investment compensation under the rule, which instead defines "portfolio investment" and "portfolio investment compensation" to broadly cover compensation that could reduce the value of a private fund's assets. However, to the extent that a fund bears a broken deal expense, rule 211(h)(1)-2(b)(2) will require its disclosure as a fund fee or expense.

i. **Portfolio Investment-Level Table. How should an adviser to a fund-of-funds determine whether it has received compensation from an entity that is a**

portfolio investment of an underlying fund that is advised by an unaffiliated adviser?

The SEC believes that a fund of funds adviser should be in a position to determine whether an entity paying the adviser, or a related person, is a portfolio investment of the fund of funds for purposes of the rule. The SEC suggests that a fund of funds adviser, for example, can request information from the payor regarding whether certain underlying funds hold an investment in the payor. The fund of funds adviser can also request a list of investments from the underlying funds to determine whether any of those underlying portfolio investments have a business relationship with the adviser or its related persons. The SEC recognized, however, that despite their best efforts, certain fund of funds advisers may lack information or may not be given information in respect of underlying entities and may have to rely on good faith belief to determine which entity or entities constitute a portfolio investment under the rule. In such instances, the SEC suggests that an adviser should document this determination, in addition to its initial and ongoing diligence efforts in making with this determination.

j. **Portfolio Investment-Level Table. How should an adviser disclose portfolio investment compensation paid to the private fund adviser and another party, such as co-investor?**

The rule requires advisers to disclose the amount of portfolio investment compensation attributable to a private fund's interest in a covered portfolio investment. Such amounts should not reflect the portion attributable to any other person's interest in the covered portfolio investment. For example, if the private fund and another person co-invested in the same portfolio investment and the portfolio investment paid the private fund's adviser a monitoring fee, the table would list the total dollar amount of the monitoring fee attributable only to the fund's interest in the portfolio investment.

k. **Portfolio Investment-Level Table. Should an adviser disclose the names of the portfolio investments as part of the portfolio investment compensation disclosure?**

The SEC believes that advisers should generally disclose the identity of each covered portfolio investment to the extent necessary for an investor to understand the nature of the potential or actual conflicts associated with such payments. To the extent the identity of any covered portfolio investment is not necessary for an investor to understand the nature of the conflict, the SEC stated that advisers may use consistent code names (e.g., "portfolio investment A").

l. **General. How should an adviser disclose any offsets, rebates, or waivers in the adviser compensation, fund fees, and portfolio investment compensation tables?**

The rule requires advisers to disclose the dollar amount of each category of adviser compensation, fund expense, and portfolio investment compensation both before and after the

application of any offsets, rebates, or waivers for the reporting period, including any offsets or rebates carried forward during the reporting period to subsequent reporting periods.

m. Performance. Do the Rule's performance reporting requirements differ based on the type of private fund?

Yes. The rule requires advisers to "liquid funds" to show performance based on net total return on an annual basis for the 10 fiscal years prior to the quarterly statement or since the fund's inception (whichever is shorter), over one-, five-, and 10-fiscal year periods, and on a cumulative basis for the current fiscal year as of the end of the most recent fiscal quarter. For "illiquid funds," the rule requires advisers to show performance based on internal rates of return and multiples of invested capital since inception and to present a statement of contributions and distributions. Accordingly, to comply with these requirements, an adviser must first to determine whether its private fund client is an illiquid or liquid fund, as defined in the rule, no later than the time the adviser sends the initial quarterly statement.

n. How should an adviser determine whether a private fund client is a liquid or illiquid fund?

The rule defines an "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. The rule defines a "liquid fund" as any fund that is not an illiquid fund. The SEC stated that generally most private equity and venture capital funds will likely fall under the illiquid fund definition, but recognizes that even traditional, closed-end private equity funds have certain redemption or withdrawal rights for regulatory events (e.g., redemptions related to the Employee Retirement Income Security Act ("ERISA") and the Bank Holding Company Act ("BHCA")) and other extraordinary circumstances (e.g., redemptions related to a violation of a State pay-to-play law). Even with these withdrawal rights, the SEC stated that such funds would still be classified as illiquid funds.

o. Performance. For purposes of performance reporting for illiquid funds, how should an adviser factor in any fund-level subscription facilities?

An adviser is required to disclose performance figures with and without the impact of fund-level subscription facilities.

p. Performance. For purposes of performance reporting, should an adviser include gross and/or net figures?

In general, the rule requires advisers to present each performance metric on a gross and net basis. However, for purposes of complying with the rule's requirement to disclose the internal rate of return and the multiple of invested capital for the realized and unrealized portions of an illiquid fund's portfolio, the rule only requires the adviser to disclose gross performance.

q. Performance. For purposes of performance reporting for illiquid funds, how should an adviser determine whether an investment is realized or unrealized?

The rules does not prescribe a methodology for an adviser to determine whether an investment is realized or unrealized. Instead, the SEC stated that an adviser must rely upon its discretion to determine whether an investment has been realized based on the specific facts and circumstances. Nevertheless, the SEC stressed the importance of advisers remaining consistent in how they make these determinations over time. Additionally, the rule requires that an adviser prominently disclose in a quarterly report the methodology it uses to make such determination.

r. Performance. What other information must an adviser disclose in connection with the required performance figures?

An adviser must provide "prominent" disclosure of the criteria used and assumptions made in calculating the performance provided in the quarterly report. The adviser must include this information directly in the quarterly report; the adviser may not provide the information only in a separate document, website hyperlink or QR code, or other separate disclosure.

3. Quarterly Statement Delivery and Distribution.

a. When must an adviser deliver quarterly statements to the private fund investors?

An adviser must distribute quarterly statements to private fund investors within 45 days of the end of the first three quarters of the year (75 days for funds of funds) and within 90 days after the end of the fiscal year (120 days for funds of funds). An adviser must prepare its first quarterly statement once a private fund client has at least two full fiscal quarters of operating results. However, the SEC stated that it would take the position that, if an adviser is unable to deliver the quarterly statement in the timeframe required under the rule due to reasonably unforeseeable circumstances (e.g., the sudden departure of senior financial employees), this 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.

b. How must advisers distribute quarterly statements to private fund investors?

An adviser generally will satisfy the requirement to "distribute" the quarterly statements when the statements are sent to all investors in the private fund. The quarterly statement can be satisfied either through paper or electronic means consistent with existing Commission guidance on electronic delivery of documents.

c. Can an adviser provide the quarterly statement information through a data room?

Yes, provided that this distribution, like other electronic deliveries, is conducted in accordance with the SEC's guidance regarding electronic delivery. For example, if an adviser notifies investors when the quarterly statements are uploaded to the data room within the applicable time period under the rule for preparation and delivery of the quarterly statement and ensures that investors have access to the quarterly statement included therein, an adviser would generally satisfy the distribution requirement. If an adviser distributes a quarterly statement electronically through a data room, such adviser must keep records of the notifications provided to investors that such quarterly statement has been made available in the data room. Such notification records must include each addressee and the date(s) the notification was sent.

d. How does an adviser satisfy the Rule's delivery requirement for an investor that is itself a pooled investment vehicle?

In circumstances where an investor is itself a pooled vehicle that is controlling, controlled by, or under common control with (i.e., is in a "control relationship" with) the adviser or its related persons, the adviser must look through that pool (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure), in order to send the quarterly statements to investors in those pools. Outside of a control relationship, such as if the private fund investor is an unaffiliated fund of funds, the adviser should distribute the quarterly statement to the adviser or other designated party of the unaffiliated fund of funds.

4. If a registered investment adviser sub-advises a private fund and the fund's primary adviser is not subject to the quarterly statement rule, will the rule still apply to the sub-adviser?

Yes, provided that the sub-adviser is otherwise subject to the rule.

5. Can an adviser include information in a quarterly statement in addition to what is required under the Rule?

Yes, however, doing so may implicate other Advisers Act rules. For example, if an adviser includes information in a quarterly report that could be construed as offering new advisory services to the private fund investors, the information could be subject the Advisers Act marketing rule (Rule 206(4)-1). Additionally, a quarterly statement is subject to the antifraud provisions of the Federal securities laws.

6. Does the quarterly statement rule impose any formatting requirements for the quarterly statements?

The rule requires that certain information disclosed in the quarterly statement is presented in a tabular format. The Rule also states that the quarterly statement must use clear, concise, plain English and be presented in a format that facilitates review from one quarterly statement to the next. The SEC also encourages advisers to use a structured, machine-readable format if advisers

believe this format will be useful to the investors in their funds. Aside from these requirements, the quarterly statement rule does not impose any additional prescriptive formatting requirements.

7. Does the quarterly statement rule contemplate consolidated reporting for multiple funds advised by an adviser?

Yes. The rule requires advisers to consolidate reporting for similar pools of assets (e.g., a fund that employs a master-feeder structure with feeder funds that invest all, or substantially all, of their investable capital in a single master fund) to the extent doing so provides more meaningful information to the private fund's investors and is not misleading. Because this requirement entails a principles-based assessment, an adviser must consider the facts and circumstances to determine whether consolidated reporting for any fund structure is appropriate.

8. What records must an adviser maintain in connection with the quarterly statement rule?

The SEC amended the Advisers Act recordkeeping rule (Rule 204-2) to require that advisers make and retain the following records:

- Copies of any quarterly statement distributed to fund investors pursuant to the Quarterly Statement Rule, as well as a record of each addressee and the date(s) the statement was sent;
- All records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any quarterly statement delivered pursuant to the Quarterly Statement Rule; and
- Books and records substantiating the adviser's determination that a private fund client is a liquid fund or an illiquid fund pursuant to the quarterly statement rule.

C) MANDATORY AUDIT RULE – RULE 206(4)-10

1. Who does the mandatory audit rule apply to?

The audit rule will apply to all investment advisers registered, or required to be registered, with the SEC that advise a private fund (other than a securitized asset fund).

2. How does the audit rule interact with the Advisers Act custody rule (Rule 206(4)-2)?

The audit rule requires a registered investment adviser to cause any private fund that it advises to undergo a financial statement audit that meets the requirements set forth in paragraphs (b)(4)(i) through (b)(4)(iii) of the Advisers Act custody rule. Thus, many private fund advisers already comply with this requirement. Because a surprise examination under the custody rule will not satisfy the requirements of the audit rule, the audit rule will effectively

eliminate the custody rule's surprise examination option under the custody rule private funds managed by a registered adviser.

3. **What are the delivery requirements for the financial statement audits required by the audit rule?**

Like the Advisers Act custody rule, the audit rule requires a fund's audited financial statements to be distributed to current investors in a private fund within 120 days of the end of the private fund's fiscal year (and within 180 days of the end of a fiscal year for a fund-of-funds and 260 days for a fund-of-fund-of-funds). The SEC also noted that if an adviser is unable to deliver audited financial statements in the timeframe required under the audit rule due to reasonably unforeseeable circumstances, this would not provide a basis for enforcement action so long as the adviser reasonably believed that the audited financial statements would be distributed by the deadline and the adviser delivers the financial statements as promptly as practicable.

4. **Does the audit rule require that the financial statement audits are prepared in accordance with U.S. generally accepted accounting principles (GAAP)?**

Yes, the audit rule will require that the audited financial statements are prepared in accordance with GAAP, as currently required under the Advisers Act custody rule. Consistent with the SEC's current position on the custody rule, the SEC stated that for purposes of the audit rule, the audited financial statements for an offshore fund or a fund that has an offshore adviser, general partner, or manager may be prepared in accordance with another comprehensive body of accounting standards similar to U.S. GAAP (e.g., International Financial Reporting Standards) provided that the financial statement audit contains information substantially similar to statements prepared in accordance with U.S. GAAP and the differences are reconciled to U.S. GAAP.

5. **How will the audit rule apply to an investment adviser that advises a private fund, but does not "control" the fund or is not under common control with the fund (e.g., an unaffiliated investment adviser sub-advises the fund)?**

In such instances, the audit rule requires that the adviser takes "all reasonable steps" to cause the private fund to undergo an audit that meets the elements of the rule. The SEC stated that what constitutes "all reasonable steps" depends on the facts and circumstances. For example, if a private fund is sub-advised by an unaffiliated sub-adviser, the SEC suggested that an adviser could include (or seek to include) a requirement in the sub-advisory agreement for the sub-adviser to obtain an audit of the fund that complies with the audit rule. Additionally, the SEC amended the Advisers Act recordkeeping rule (Rule 204-2) to require that the adviser keeps a record documenting steps it has taken to cause a private fund client with which it is not in a control relationship to undergo a financial statement audit that complies with the audit rule.

6. **If an adviser to a private fund utilizes one or more special purpose vehicles (SPV) to facilitate the private fund's investments for legal, tax, regulatory or similar purposes,**

will the audit rule require that the adviser obtain a separate financial statement audit for that SPV?

Consistent with its current position for custody rule audits, the SEC stated that for purposes of the audit rule an investment adviser could either treat an SPV as a separate client or treat the SPV's assets as assets of the pooled investment vehicles that it is advising indirectly through the SPV. If the adviser treats the SPV as a separate client, the audit rule will require the adviser to comply with the rule's audited financial statement distribution requirements and distribute the SPV's audited financial statements to the private fund's beneficial owners. If, however, the adviser treats the SPV's assets as the private fund's assets that it is advising indirectly, the SPV's assets will be required to be considered within the scope of the private fund's financial statement audit.

7. **If an investment adviser is located offshore and advises an offshore fund, can it satisfy the audit rule by obtaining a financial statement audit by an accountant that is overseen by a regulator in the local jurisdiction, rather than the PCAOB?**

The audit rule requires that the accountant conducting the audit must be registered with, and subject to inspection by, the PCAOB. However, the SEC reiterated its longstanding position that the substantive provisions of the Advisers Act and its rules, including the audit rule, do not apply with respect to non-U.S. clients (including private funds) of an SEC registered offshore investment adviser. Thus, the audit rule will not require a registered investment adviser that is located offshore to obtain financial statement audits of the offshore private funds it advises.

8. **Does the audit rule require that an adviser obtain a financial statement audit upon liquidation of a private fund it advises?**

Yes, the audit rule incorporates the Advisers Act custody rule requirement that audits must be performed promptly upon the liquidation of a private fund.

D) ADVISER-LED SECONDARIES RULE (Rule 211(h)(2)-2)

1. **Who does the adviser-led secondaries rule apply to?**

The quarterly statement rule will apply to all investment advisers registered, or required to be registered, with the SEC that advise a private fund (other than a securitized asset fund).

2. **What is considered an "adviser-led secondary transaction"?**

A transaction initiated by an adviser or a related person that offers fund investors the option between (i) selling all or a portion of their interests in a private fund (i.e., obtaining liquidity) and (ii) converting or exchanging them for new interests in another vehicle advised by the adviser or any of its related persons (i.e., rolling over), including single asset transactions (sale of a single

asset), strip sale transactions (sale of a portion of multiple assets), and full fund restructurings (sale of all assets).

The SEC will generally consider a transaction to be initiated by an adviser if the adviser commences a process, or causes one or more other persons to commence a process, that is designed to offer private fund investors the option to obtain liquidity for their private fund interests. This requires a fact and circumstances analysis.

Recognizing concerns that this broad definition might be capturing certain types of transactions that would not raise the same regulatory and conflict of interest concerns, the SEC confirmed in their release that the following transactions would generally not be deemed an "adviser-led secondary transaction":

- *LP Transfers:* The adviser, at the unsolicited request of the investor, assists in the secondary sale of such investor's fund interest;
- *Rebalancing/ Season and Sell:* Rebalancing between parallel funds and season and sell transactions between parallel funds (the SEC differentiates between (i) offering investors the choice between selling and converting/exchanging their interests in the private fund and (ii) moving or reallocating assets between private funds for legal and/or tax reasons); and
- *Tender Offers:* Tender offers that do not offer investors the choice between selling and converting/exchanging their interests in the private fund. If an investor is allowed to retain its interest in the same fund with respect to the asset subject to the transaction on the same terms (i.e., the investor is not required to either sell or convert/exchange), then the transaction would not qualify as an adviser-led secondary transaction.

3. Who is considered a "related person" of an adviser?

"Related persons" include: (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser. The definitions for "related persons" and "control" are the same as those used in Form ADV.

4. What are the requirements of the adviser-led secondaries rule?

If a secondaries transaction is an "adviser-led secondary transaction," then:

- The adviser must obtain a fairness opinion or a valuation opinion from an independent opinion provider (i.e., a person that provides fairness opinions or valuation opinions in the ordinary course of its business that is not a related person of the adviser) and distribute the opinion to each investor in the private fund prior to the due date of the election form for the transaction; and

- The adviser must prepare and distribute a written summary of any material business relationships between the adviser or its related persons and the independent opinion provider and distribute the summary to each investor in the private fund prior to the due date of the election form for the transaction.

5. **Does the opinion need to cover anything other than price/ valuation?**

No, only the price/ valuation of the transaction needs to be covered. The other terms of the transaction do not need to be covered by the opinion.

6. **How early can the opinion be dated? When does the opinion become stale?**

The SEC did not specify within what timeframe from the closing of the secondaries transaction, or the adviser's solicitation of investor interest in the transaction, the opinion must be delivered. However, in responding to one comment, the SEC noted that valuations obtained within 12 months of the adviser's solicitation of investor interest in the adviser-led secondary transaction is too long a period and would not allow the price to reflect the market's more recent pricing changes.

7. **What needs to be covered by the summary of material business relationships?**

Any material business relationships the adviser or any of its related persons has, or has had, with the independent opinion provider within the two-year period immediately prior to the issuance date of the fairness opinion or valuation opinion.

Whether a business relationship is material requires a facts and circumstances analysis; however, for purposes of the rule, audit, consulting, capital raising, investment banking, and other similar services would typically meet this standard.

8. **What records related to the opinion and summary of material business relationships need to be kept?**

Advisers must make and retain a copy of the fairness opinion or valuation opinion and material business relationship summary distributed to investors, as well as a record of each addressee and the date(s) the opinion and summary was sent.

Advisers do not need to make and retain records of the addresses or delivery methods used to disseminate opinions or material business relationship summaries.

9. **What should parties consider when negotiating governing documents going forward?**

Under the New Rules, advisers and investors have the ability to negotiate whether a fairness opinion or valuation opinion is more appropriate, and who bears the costs associated with such opinion. These can be predetermined in the governing agreements of the private fund.

E) RESTRICTED ACTIVITIES RULE (Rule 211(h)(2)-1)

1. Who does the restricted activities rule apply to?

The restricted activities rule applies to all investment advisers to a U.S. private fund *(other than a securitized asset fund)*, including registered advisers and exempt reporting advisers. The rule also applies to an investment adviser's related persons. Meaning, even if the activities described in the restricted activities rule are performed indirectly by an adviser's related persons, compliance with the specified disclosure and consent requirements is necessary.

2. The restricted activities rule includes certain disclosure and, in some cases, consent exceptions. Which exceptions apply to which activities?

Activity	Disclosure-Only Exception	Consent Exception
Investigation expenses (*except for expenses related an investigation that results in sanctions under the Advisers Act*)	N/A	Prior consent by at least a majority in interest of the fund's investors that are not related persons of the adviser
Regulatory, compliance and examination expenses	Must be disclosed within 45 days after the end of the fiscal quarter in which the relevant activity occurs	N/A
Reducing adviser clawbacks for taxes	Must be disclosed within 45 days after the end of the fiscal quarter in which the relevant activity occurs	N/A
Non-pro rata fee and expense allocations	Prior notice required	N/A
Borrowing from a private fund client	Distribute to each investor a written description of the material terms of such borrowing, loan, or extension of credit	Prior consent by at least a majority in interest of the fund's investors that are not related persons of the adviser

3. Is disclosure to, or consent by, an Advisory Committee sufficient?

No, the disclosure exceptions require that an adviser distribute written notice to all investors in the private fund. Similarly, each consent-based exception requires an adviser to seek consent for the restricted activity from all the fund's investors and receive consent from at least a majority in interest of the fund's investors that are not related persons of the adviser.

4. **Do advisers need to look through investors that are pooled investment vehicles for purposes of applying the disclosure or consent exceptions?**

Yes, if the pooled vehicle is in a control relationship with the adviser.

The definition of "distribute," "distributes," and "distributed" precludes advisers from using layers of pooled investment vehicles in a control relationship with the adviser to avoid meaningful application of the distribution requirement. In circumstances where an investor is itself a pooled vehicle that is controlling, controlled by, or under common control with (a "control relationship") the adviser or its related persons, the adviser must look through that pool (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure) and send the written notice or consent request to investors in those pools. Outside of a control relationship, such as if the private fund investor is an unaffiliated fund of funds, this same concern is not present, and the adviser would not need to look through the structure to make delivery that satisfies the definition of "distribute."

5. **What is the required consent threshold? Can this threshold be altered by agreement?**

Each consent-based exception requires an adviser to obtain consent from at least a majority in interest of investors that are not related persons of the adviser.

A fund's governing documents may establish that a higher threshold of investor consent is necessary and may generally prescribe the manner and process by which the applicable threshold of investor consent is obtained. For example, the fund's governing documents may provide for the exclusion of defaulting investors and/or non-voting interests for voting purposes.

6. **What does disclosure entail? Does disclosure in the PPM and consent via a governing agreement suffice? Can the required disclosure be combined with other reports?**

Please refer to questions 8.b, 11.e and 12.c below, which discuss the disclosure and consent requirements applicable to each restricted activity.

Advisers that are subject to the quarterly statement rule can include disclosures that are required by the restricted activities rule within 45 days after the end of the fiscal quarter in which the relevant activity occurs in their quarterly reports. A separate report does not need to be distributed to the extent that the quarterly report is being delivered within the 45-day timeframe required by the restricted activities rule.

7. **What records related to disclosure and consent should be maintained?**

SEC-registered investment advisers must retain a copy of any notification, consent, or other document distributed to or received from private fund investors pursuant to the restricted activities rule, along with a record of each investor to whom such document was sent and the date(s) of distribution to each such investor.

Advisers do not need to maintain a record of the addresses or delivery methods used to disseminate any notifications or other documents to private fund investors pursuant to the restricted activities rule.

8. Rule 275.211(h)(2)-1(a)(1): Investigation Expenses

a. Investigation Expenses: What expenses are captured by the rule?

Expenses associated with an investigation related to an adviser's own misfeasance. While not explicit in the Release, the language used suggests that the SEC is differentiating between expenses relating to investigations of misfeasance (which are subject to a consent-based exception) and routine examinations (which would be covered by Rule 275.211(h)(2)-1(a)(2) and subject to a disclosure-only based exception).

Importantly, in its Release, the SEC reiterated that charging expenses related to an investigation of the adviser or its related persons without authority in the governing documents is inconsistent with an adviser's fiduciary duty. In other words, a private fund's governing documents must explicitly allow an adviser to charge or allocate these expenses to such fund before such amounts are even charged or allocated to the fund. Disclosure after-the-fact, as is required by the New Rules, does not "cleanse" unauthorized allocations or charges of regulatory, compliance, and examinations expenses.

The consent-based exception for an adviser to charge a fund for fees or expenses related to an investigation specifically excludes fees and expenses of an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Advisers Act or the rules promulgated thereunder. Such charges will be outright prohibited.

b. Investigation Expenses: The rule requires prior consent by at least a majority in interest of a fund's investors. Does a general consent, such as in the governing documents of a private fund suffice?

Likely, no. The New Rules and the Release are not explicit on this point. However, the discussion in the Release suggests that the SEC did not intend for a general consent at the time of investment to suffice:

- The Release discusses the need for disclosure of the specific fees and expenses actually being passed through to funds relating to a particular investigation and securing consent from investors with respect to such amounts; and
- The estimates published in the Release assume consent forms will be issued during the life of a fund and that advisers will need to collect, retain, and track consent forms, both of which suggest that the SEC has not contemplated consent being obtained on a one-off basis as part of the investment process.

c. **Are estimates ok? What if the investigation results in a sanction after certain fees have already been charged to a fund?**

The Release does not specify the timing of the consent solicitation and whether to allow for such timing estimate that may be used. Rather, the Rules require that the consent be obtained before the fee or expense is charged or allocated to the fund. This suggests that the adviser can wait to solicit consent until the amount is known by the adviser. Conversely, the SEC noted in the Release that they "recognize that governmental or regulatory bodies may not formally notify an adviser that it is under investigation. In such a circumstance, whether an adviser is under investigation would be determined based on the information available." This seems to suggest the adviser may seek advance approval of estimated amounts. Further clarification by the SEC is needed on this topic.

d. **What if investors do not respond? Could a deemed consent clause apply?**

The Release does not cover this topic. This is one area where further clarification by the SEC is needed.

e. **Investigation Expenses: What should parties consider when negotiating governing documents going forward?**

The SEC recognizes that whether such fees and expenses are charged to a private fund can be highly negotiated by investors in certain instances. A prohibition of certain of these charges without an exception for instances in which the adviser obtains investor consent could result in unfavorable outcomes for investors. For example, some advisers may attempt to increase management or other fees if they were no longer able to charge such fees and expenses to fund clients, and the increase in management fees might have been more than the increase in any fees or expenses already being passed through to the private fund.

For these reasons, it might be permissible for investors and advisers to pre-agree to what investigation expenses the investors will provide their consent to. This would still require the adviser to provide information on such expenses and solicit consent but would shift (some of) the risk to investors with the intent of discouraging advisers from raising management fees. An example of this would be an agreement by the investors in the governing documents to promptly provide their consent to fees related to an investigation of the adviser under a certain amount provided that the investigation does not relate to certain bad acts. Industry practice will likely shape how investigation costs are approached in the future as the New Rules are clarified, further interpreted, and implemented.

9. **Rule 275.211(h)(2)-1(a)(2): Regulatory, Compliance and Examination Expenses**

a. **Regulatory, Compliance and Examination Expenses: What expenses are captured by the rule?**

Fees and expenses charged or allocated to a private fund for (i) regulatory or compliance fees and expenses of the adviser or its related persons and (ii) fees and expenses associated with an examination of the adviser or its related persons by any governmental or regulatory authority.

The SEC specifically declined to clarify which fees and expenses are related to an adviser's activities (and captured by the rule) vs. a fund's activities. However, the SEC's intent seems to be to capture costs incurred as a result of legal and regulatory obligations imposed on advisers in connection with providing advisory services generally that could otherwise be described as "overhead" or the adviser's "risk of doing business" and that would not be unreasonable for the adviser to pay out of its own resource. The examples used in the Release included:

- Filing and other fees associated with SEC filings, such as Form ADV and Form PF, as well as certain state filings;
- Fees an adviser pays to a compliance consultant to assess the adviser's compliance program; and
- Fees and expenses for a compliance consultant to help an adviser with mock or real examinations.

These examples are not comprehensive and should be used for illustrative purposes only.

Importantly, in its Release, the SEC reiterated that charging regulatory, compliance and examinations expenses without authority in the governing documents is inconsistent with an adviser's fiduciary duty. In other words, a private fund's governing documents must explicitly allow an adviser to charge or allocate these fees and expense to such fund before such amounts are even charged or allocated to the fund. Disclosure after-the-fact, as is required by the New Rules, does not "cleanse" unauthorized allocations or charges of regulatory, compliance and examinations expenses.

b. Regulatory, Compliance and Examination Expenses: What if an examination results in deficiencies or findings? Would that be considered a "sanction" such that the related expenses cannot be charged to a private fund?

Likely, no. The New Rules and the Release do not define "sanction" but the prohibition on charging expenses related to an investigation resulting in sanctions is set forth in Rule 275.211(h)(2)-1(a)(1), which covers investigation related to an adviser's own misfeasance. While not explicit in the Release, the language used suggests that the SEC is differentiating between (i) expenses relating to investigations of misfeasance (which are subject to a consent-based exception), and any related sanctions, and (ii) routine examinations (which are subject to a disclosure-based exception), and any related findings or deficiencies. For these reasons, fees and expenses related to examinations resulting in findings or deficiencies can likely be charged to a fund, provided that the required disclosures are made.

c. Regulatory, Compliance and Examination Expenses: What information must be disclosed?

Advisers must disclose the fees and expenses described above (see "Regulatory, Compliance and Examination Expenses: What expenses are captured by the rule?"), and the dollar amounts thereof, in writing within 45 days of the end of the applicable quarter.

The written notice should generally include a detailed accounting of each category of applicable fees and expenses. Advisers should generally list each specific category of fee or expense as a separate line item and the dollar amount thereof, rather than group such fees and expenses into broad categories such as "compliance expenses."

In preparing these disclosures, advisers should keep in mind that the SEC adopted these rules to address what they believed to be a lack of transparency in the industry. The SEC highlighted the risk that even if investors contractually agree, with appropriate initial disclosure, to bear an adviser's specified fees and expenses, they may be deceived to the extent the adviser does not disclose the total dollar amount of such fees and expenses after the fact. Investors may also be deceived if advisers describe such fees and expenses so generically as to conceal their true nature and extent. Thus, in determining what level of detail to disclose, advisers should ensure that their disclosures are sufficiently addressing these concerns.

d. Regulatory, Compliance and Examination Expenses: What should parties consider when negotiating governing documents going forward?

Because the SEC specifically declined to clarify which fees and expenses are captured by the rule, investors should be prepared to negotiate, as part of the investment process, what items are considered regulatory, compliance and examination fees and expenses of the adviser or its related persons, if there are any items the investor would like disclosure on that might not squarely be described as a "regulatory, compliance and examination fees and expenses of the adviser or its related person." This will ensure that investors receive the information they expect to receive under the New Rule.

Advisers should pay careful attention to the fund expense provisions and related disclosures. Any relevant items should be drilled down on and cross-referenced between the expense and disclosure provisions. This will help ensure the required disclosure list is complete and that the adviser is authorized to allocate such amounts to the fund to avoid any breach of fiduciary duty concerns.

10. Rule 275.211(h)(2)-1(a)(3): Reducing Adviser Clawbacks for Taxes

a. Reducing Adviser Clawbacks for Taxes: Does this mean advisers are now required to include a clawback mechanism in the governing documents of the private funds they advise?

No. The existence of a clawback mechanism and its terms are still subject to negotiation by investors and advisers. Investors may agree that no clawback is required or that the clawback

may be reduced by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.

b. Reducing Adviser Clawbacks for Taxes: What exactly must be disclosed?

Within 45 days after the end of the fiscal quarter in which the clawback occurs, an adviser must distribute a written notice to the investors of the private fund that sets forth the aggregate dollar amounts of the adviser clawback both before and after the application of any tax reduction. These aggregate dollar amounts should reflect the gross amount of excess compensation received by the adviser (or its related persons) that is being clawed back.

c. Reducing Adviser Clawbacks for Taxes: What should parties consider when negotiating governing documents going forward?

Parties should consider whether any additional information can be offered, or should be requested, in connection with the disclosures described above. Examples include:

- Information regarding currently estimated clawback amounts (with respect to advisers that routinely monitor their potential clawback liability);
- Information clarifying an investor's respective share of the reduction;
- Information regarding the adviser's related determinations and calculations.

11. Rule 275.211(h)(2)-1(a)(4): Non-Pro Rata Fee and Expense Allocations

a. Non-Pro Rata Fee and Expense Allocations: What fees and expenses are captured by the rule?

Fees and expenses related to a portfolio investment (or potential portfolio investment) are captured by Rule 275.211(h)(2)-1(a)(4). Examples in the Release include:

- Asset-level due diligence, accounting, valuation, and legal expenses and costs related to a portfolio investment (or potential portfolio investment), which may either be incurred in-house or through the use of a third party;
- Research expenses, travel costs, professional fees, and other expenses incurred in deal sourcing activities;
- Broken-deal fees and other costs related to portfolio investments that never materialize.

Fees and expenses related to the operations of a private fund generally, such as the management fee charged by the adviser, are not captured by Rule 275.211(h)(2)-1(a)(4).

Importantly, in its Release, the SEC noted that allocating fees and expenses on a non-pro rata basis may also violate antifraud provisions of the Advisers Act if an adviser contravenes representations within the fund governing documents. In other words, a private fund's governing documents must explicitly allow an adviser to charge or allocate these fees and expense on a

non-pro rata basis. Disclosure after-the-fact, as is required by the New Rules, does not "cleanse" unauthorized allocations or charges.

b. **Non-Pro Rata Fee and Expense Allocations: How is pro rata defined by the SEC?**

It is not. The SEC acknowledged there may be multiple methods to determine pro rata allocations and that there is some subjectivity regarding how advisers calculate pro rata in a fair and equitable manner. They have therefore declined to define "pro rata."

c. **Non-Pro Rata Fee and Expense Allocations: What are the requirements of the exception?**

First, the non-pro rata charge or allocation must be fair and equitable under the circumstance. Whether it is fair and equitable will depend on factors relevant for the specific expense. For example, it would be relevant whether the expense relates to a specific type of security that one private fund holds. In another example, a factor could be whether the expense relates to a bespoke structuring arrangement for one private fund to participate in the portfolio investment. As yet another example, another factor could be that one private fund may receive a greater benefit from the expense relative to other private funds advised by the adviser, such as the potential benefit of certain insurance policies.

Second, prior to charging or allocating such fees or expenses to a private fund, the adviser must distribute to each investor a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances.

d. **Non-Pro Rata Fee and Expense Allocations: What information should be included in the notice?**

The SEC has not prescribed the level of detail required in the advance notice to investors. That being said, advisers should consider addressing the SEC's concerns relating to non-pro rata allocations, such as:

- Whether the adviser's allocation approach creates any conflicts of interest;
- Whether the adviser's allocation results in any additional direct or indirect compensation to the adviser or its related parties; and
- Whether the adviser's allocation creates the risk of potential harms, or results in other disadvantages related to such activity.

Addressing these factors in the notice will also help ensure (and explain how) the allocation is fair and equitable under the circumstances.

e. **Non-Pro Rata Fee and Expense Allocations: How much in advance does the notice need to be distributed?**

The SEC did not set a minimum timeframe with respect to delivery of notice. In determining the timing of when to deliver such notices, advisers should keep in mind that one objective of the New Rules is to enable investors to discuss the non-pro rata allocation with the adviser before being charged. Meaning, sufficient time for discussion should be accounted for in determining the timing of sending out the required notices.

f. Non-Pro Rata Fee and Expense Allocations: Does a general disclosure of an expense allocation policy and related procedures (for example in a PPM or as part of a diligence package circulated during the fundraising process) suffice?

Likely no. Some comments received by the SEC prior to their adoption of the New Rules proposed that advisers disclose their policies and procedures regarding the allocation of fees and expenses among private funds to each fund investor. The SEC specifically declined to adopt this approach.

g. Non-Pro Rata Fee and Expense Allocations: How does this rule apply to co-investments and costs related to unconsummated investments?

Many co-investments are executed on short notice and the related fees and expenses are allocated at or shortly after closing, raising potential timing concerns. The SEC noted that the disclosure requirements can be completed as part of an investor's review of the transaction documents and their subscription (and prior to the adviser completing the non-pro rata charge or allocation). The investor does not have to be admitted to the co-investment vehicle prior to the disclosure being made.

The Release is clear that the New Rules are intended to capture fees and expenses related to unconsummated investments, including broken-deal fees. However, the Release does not address the scenario where the prospective co-investment vehicle is never formed (although it would have been formed had the investment proceeded to closing), so that there is no other client or investment vehicle of the adviser to split costs with (pro rata or otherwise). The SEC might take the approach that non-disclosure of such amounts would be doing indirectly what the adviser is not permitted to do directly (i.e., by declining to form the vehicle until the last minute to avoid broken-deal fees and the related disclosures) and therefore prohibited.

12. Rule 275.211(h)(2)-1(a)(5): Borrowing from a Private Fund Client

a. Borrowing from a Private Fund Client: What does "borrowing" include?

Directly or indirectly borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client.

The SEC confirmed that it would not interpret ordinary course tax advances and management fee offsets as borrowings that are subject to this rule.

b. Borrowing from a Private Fund Client: Are borrowings from fund investors captured by this rule?

No, the News Release clarifies that the restriction will not apply to borrowings from a third party on the fund's behalf or to the adviser's borrowings from individual investors outside of the fund, such as a bank that is invested in the fund; instead the restriction focuses on the types of borrowings that result in the adviser being on both sides of the agreement (for example, borrowing from a private fund, which it is authorized to act for).

c. Borrowing from a Private Fund Client: What must be disclosed in the solicitation for consent?

The disclosure must be clear and detailed enough for the client to make an informed decision to consent to the conflict of interest or reject it. The SEC did not enumerate specific terms of the borrowing that must be disclosed in connection with an adviser's consent request; rather, the rule requires advisers to disclose the prospective borrowing and the material terms related thereto. This could include, for example, the amount of money to be borrowed, the interest rate, and the repayment schedule, depending on the facts and circumstances.

d. Borrowing from a Private Fund Client: What should parties consider when negotiating governing documents going forward?

By not enumerating specific terms that must be disclosed and instead incorporating a materiality standard, the SEC specifically intended to afford investors and advisers the flexibility to negotiate for disclosures and terms that are tailored to their unique needs and relationships.

F) PREFERENTIAL TREATMENT RULE (Rule 211(h)(2)-3)

1. Who does the preferential treatment rule apply to?

The preferential treatment rule applies to all investment advisers to a U.S. private fund *(other than a securitized asset fund)*, including registered advisers and exempted reporting advisers. The rule also applies to an investment adviser's related persons. Meaning, even if the activities described in the preferential treatment rule are performed indirectly by an adviser's related persons, compliance with the specified disclosure and consent requirements is necessary.

2. Who is considered a "related person" of an adviser for purposes of the preferential treatment rule?

"Related persons" include: (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common

control with the adviser. The definitions for "related persons" and "control" are the same as those used in Form ADV.

3. **The preferential treatment rule includes several exceptions. Which exceptions apply to which activities?**

Activity	Preferential Treatment is Required by Law	Preferential Treatment is Offered to all Investors	Preferential Treatment is Disclosed*
Redemption rights that have a material, negative effect on other investors *in a similar pool of assets*	Yes	Yes	No
Information rights regarding portfolio holdings that have a material, negative effect on other investors *in a similar pool of assets*	No	Yes	No
Any right that treats an investor preferentially over other investors *in the same private fund*	No	No	Yes

* All preferential terms (including redemption and information rights) must be disclosed to prospective and existing investors under Rule 211(h)(2)-3(b). A "yes" in this column indicates that disclosure acts as an exception to the prohibition against offering such rights.

4. **The prohibition against redemption rights and information rights regarding portfolio holdings excludes rights offered to all other investors requires "in a similar pool of assets."**

    a. **Similar pool of assets. What if preferential treatment is given to an investor in a parallel fund? Does the right need to be offered to all investors in the main fund?**

Yes. The rule applies with respect to preferential rights granted to investors in a particular fund *and any similar pool of assets*, which means any pooled investment vehicle managed by the investment adviser or its related persons (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 particular fund.

If this seems broad, it is purposefully so. The SEC expanded the scope to capture "any similar pool of assets" rather than only "any substantially similar pool of assets" as initially proposed. The SEC acknowledged that the definition will likely capture vehicles outside of what the private funds industry would typically view as "substantially similar pools of assets." For example, 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. The SEC explained that a comprehensive definition of "similar pool of assets" was used to prevent advisers from attempting to structure around the preferential treatment prohibitions.

b. Similar pool of assets. When will a pool of assets be determined to be "similar" to a private fund?

Whether a pool of assets managed by the adviser is "similar" to the private fund requires a facts and circumstances analysis. The types of asset pools that would be included in this term would include a variety of pools, regardless of whether they are private funds. For example, this term would include limited liability companies, partnerships, and other organizational structures, regardless of the number of investors; feeders to the same master fund; and parallel fund structures and alternative investment vehicles.

The SEC noted that the following differences in a pool of assets would, subject to the facts and circumstances, likely not have substantially similar investment policies, objectives, or strategies to those of the subject private fund:

- A pool of assets with a materially different target return; and
- A pool of assets with a materially different or sector focus.

The following differences, in and of themselves, would not be sufficient to differentiate the investment policies, objectives, or strategies of a pool of assets from those of the subject private fund:

- Pooled vehicles with different base currencies; and
- Pooled vehicles with embedded leverage.

c. Similar pool of assets. What about managed accounts or a fund-of-one?

No, a managed account would not be a "similar pool of assets" to a private fund. The rule is not designed to protect against the adviser disadvantaging one client (a private fund) as a result of preferential treatment given to another client (a separately managed account client) because the fiduciary duty protects against such preferential treatment. Accordingly, there is no need to include separately managed accounts in the definition of "similar pool of assets."

A fund-of-one might be deemed to be a "similar pool of assets" to a private fund. In the Release, the SEC noted that there are certain circumstances in which a fund of one or single investor fund

can be a pooled investment vehicle and therefore can fall within the definition of "similar pool of assets." The analysis would be the same as determining whether the adviser can rely on the "advises solely private funds" exemption under the Adviser Act. Consideration should be given to whether individualized advice is being offered directly to the investors in the vehicle; whether the vehicle is seeking to raise additional capital and admit additional investors; and whether the vehicle was previously comprised of multiple investors who have since withdrawn.

d. Similar pool of assets. What about co-investment vehicles?

The same facts and circumstances analysis noted above (see "When will a pool of assets be determined to be "similar" to a private fund?") needs to be applied. The SEC views co-investment vehicles as operating in a similar fashion as other pooled investment vehicles that invest alongside the adviser's main fund, such as parallel funds, because they typically enter and exit the applicable investment(s) at substantially the same time and on substantially the same terms as the adviser's main fund. Providing investors in these vehicles with preferential information presents the same risks and circumvention concerns as other pooled investment vehicles captured by the definition.

5. What if the preferential rights are offered to a subset of investors, such as those holding a different share class?

The preferential right will violate the prohibition and the exception will not apply. To qualify for the exception, an adviser must have offered the same redemption ability to all other existing investors, regardless of what class of interest they hold, and must continue to offer such redemption ability to all future investors without qualification (e.g., no commitment size, affiliation requirements, or other limitations).

6. Do an investor's policies or resolutions count as "required by law" for purposes of the exemption to the prohibition against offering redemption rights?

No, the SEC specifically rejected the proposal that the exception be broadened to include redemptions pursuant to an investor's policies or resolutions. The exception from this rule is narrowly tailored to limit potential harms to other investors to those cases that are absolutely necessary (such as when required by pay-to-play laws or by certain state laws which would require a pension plan to redeem its interest under certain circumstances, such as a violation by the adviser of state pay-to-play, anti-boycott, or similar laws).

7. How will the "reasonably expects" standard be applied?

The standard imposes an objective standard that takes into account what the adviser reasonably expected at the time. This standard does not require advisers to make predictions; rather, it requires advisers to form only a reasonable expectation based on the facts and circumstances at the time. Although the SEC is taking the position that an adviser's decision will not be unfairly

judged in hindsight, the "reasonably expects" standard will create some level of regulatory uncertainty and advisers should err on the side of applying the standard conservatively.

8. Is there a materiality threshold?

While the rule applies to preferential rights that will have a material, negative effect on other investors and rights related to material economic terms, the SEC declined to define "material" and specifically rejected the proposal that materiality be assessed under the securities laws framework (i.e., whether there is a substantial likelihood that a reasonable investor would consider such terms significant in its decision to invest or remain in the fund). The SEC believes it is important for this standard to remain evergreen so that it can be applied to various types of arrangements between advisers and investors and fund structures.

9. What if the preferential treatment is not in writing? For example, information is disclosed in conversation to one investor.

The rule is intended to apply to all preferential treatment, regardless of whether such preferential treatment is documented in a governing document of the fund (e.g., the partnership agreement) or a side letter, or not documented at all.

If an adviser discusses their portfolio holdings during an investor meeting and the adviser reasonably expects that providing such information would have a material, negative effect on other investors in the private fund or similar pool of assets, all investors should be given access to the same information at the same time or substantially the same time.

10. When would preferential information rights not be reasonably expected to have a material, negative effect on other investors?

The SEC confirmed that they would generally not view preferential information rights provided to one or more investors in an illiquid private fund as having a material, negative effect on other investors. That being said, they declined to include a blanket exemption for all closed-end funds because, whether preferential information provided to an investor in a closed-end fund violates the final rule requires a facts and circumstances analysis. For example, if the closed-end funds offer redemption rights to certain investors, that right coupled with preferential information rights related to portfolio holdings is likely to have a material, negative effect on other investors.

11. What are the disclosure requirements? How might this impact the fundraising process?

Advance notice to prospective investors (including investors increasing their commitments) regarding material economic terms: 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 must be delivered to each prospective investor in the same private fund, *prior to the investor's investment in the private fund*.

In order to efficiently manage this process, advisers may consider consolidating closings (rather than holding several rolling closings) and delivering notices quarterly. Advisers should also consider how they will manage the process from an investor relations perspective as investors may wish to only participate in the final closing so as to get a complete list of material economic rights offered to other investors prior to closing.

Notice to existing investors in an illiquid fund of any preferential treatment: Written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund must be delivered to each investor *as soon as reasonably practicable following the end of the private fund's fundraising period*.

Notice to existing investors in an illiquid fund of any preferential treatment: Written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund must be delivered to each investor *as soon as reasonably practicable following the investor's investment in the private fund*.

Annual notice to existing investors: 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 under the rule must be delivered to each investor.

Level of detail: An adviser must describe the preferential treatment with specificity to convey its relevance.

Compendiums: An adviser could comply with the disclosure requirements by providing copies of side letters (with identifying information regarding the other investors redacted). Alternatively, an adviser could provide a written summary of the preferential terms provided to other investors in the same private fund, provided the summary specifically describes the preferential treatment.

Timing: The SEC specifically did not adopt a requirement for advisers to distribute the various notices within a specified deadline (e.g., five days after an investor's investment in the fund or five days after year end). Whether a written notice is furnished "as soon as reasonably practicable" will depend on the facts and circumstances. While this standard imposes no specific time limit, the SEC stated their belief that it would generally be appropriate for advisers to distribute the notices within four weeks.

12. What are some examples of preferential treatment related to economic terms? Does that just capture fee and carry breaks?

No, the release highlighted the scenarios set out below as examples of preferential treatment related to economic terms (the materiality of which will need to be assessed):

- An investor negotiates limitations on its indemnification obligations, which might result in other investors being required to bear an increased portion of indemnification costs.

- An investor negotiates to limit its participation in a particular investment, which might result in the aggregate returns realized by other investors being more adversely affected than otherwise by the unfavorable performance of such investment, and also resulting in other investors having a larger position in such investment (i.e., less diversification than otherwise).
- An adviser may agree to waive all, or part of the confidentiality obligation set forth in the private fund's governing agreement for one investor. Such a waiver has the potential to harm other investors because proprietary information may be made available to third parties, such as competitors of the private fund, which could negatively affect the fund's competitive advantage in, for example, seeking and securing investments.
- Co-investment rights will generally qualify as a material, economic term to the extent they include materially different fee and expense terms from those of the main fund (e.g., no fees or no obligation to bear broken deal expenses). Even if co-investment rights do not include different fee and expense terms, and for example, are offered to provide an investor with additional exposure to a particular investment or investment type, investors often negotiate for those rights and give up other terms in the bargaining process in order to secure access to co-investment opportunities. As a result, co-investment terms generally will be material given their impact on an investor's bargaining position.

13. What records related to the preferential rule need to be kept?

Advisers must make and retain a copy of the notices distributed to investors, as well as a record of each addressee and the date(s) the notice was sent.

Advisers do not need to make and retain records of the addresses or delivery methods used to disseminate notices.

Under amended Rule 204-2, registered advisers are required to retain books and records to support their compliance with the proposed preferential treatment rule, including with respect to prospective investors who ultimately did not complete their investment.

G) OTHER

1. What are other key takeaways from the Release that are not covered by the Rules themselves?

In the Release, the SEC staff reiterated its position that any waiver of an adviser's obligations under the Advisers Act, including its fiduciary duty and compliance with the anti-fraud provisions in Section 206 of the Advisers Act, is invalid. In particular, the SEC considers the following to be invalid waivers of an adviser's obligations under the Advisers Act:

- A contractual clause that purports to limit an adviser's liability and creates a conflict of interest between an adviser and the private fund, if the adviser does not address the conflict as required by its duty of loyalty.

- Reimbursement, indemnification, or exculpation for a breach of an Adviser's Federal fiduciary duty because such reimbursement, indemnification, or exculpation would operate effectively as a waiver.
- Charging a private fund fees and expenses related to an investigation that results in the imposition of sanctions against the adviser for a violation of the Advisers Act and its related rules to be invalid under the Advisers Act.

The SEC's comments underscore their enhanced scrutiny of how investment advisers are addressing conflicts and how investment advisers are narrowing their fiduciary duties by contract. Investment advisers should carefully review how conflicts are being addressed in the governing documents for the private funds they advise and ensure they are in-line with the views expressed above.

The News Release also sets out the SEC's position on charging portfolio companies for monitoring, servicing, consulting, or other fees related to services that an investment adviser does not, or does not reasonably expect to, provide to the portfolio company. The SEC considers such activity as being (indirectly) inconsistent with the adviser's fiduciary duty (and therefore prohibited *per se*).