

**Disclaimer:** On June 5, 2024, the U.S. Court of Appeals for the Fifth Circuit issued an opinion in *National Association of Private Fund Managers v. SEC*, No. 23-60471 (5th Cir. 2024) vacating the "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews" rules (the "Final Rules"). As a result, those rules that were newly adopted under the Final Rules have been vacated. Further, amendments to rules that were in effect before the Final Rules were adopted have also been vacated, such that those vacated amendments are no longer in effect.

## **SECURITIES AND EXCHANGE COMMISSION**

### **17 CFR Part 275**

**[Release No. IA-6383; File No. S7-03-22]**

**RIN 3235-AN07**

### **Private Fund Advisers; Documentation of Registered Investment Adviser Compliance**

#### **Reviews**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") is adopting new rules under the Investment Advisers Act of 1940 ("Advisers Act" or "Act"). The rules are designed to protect investors who directly or indirectly invest in private funds by increasing visibility into certain practices involving compensation schemes, sales practices, and conflicts of interest through disclosure; establishing requirements to address such practices that have the potential to lead to investor harm; and restricting practices that are contrary to the public interest and the protection of investors. These rules are likewise designed to prevent fraud, deception, or manipulation by the investment advisers to those funds. The Commission is adopting corresponding amendments to the Advisers Act books and records rule to facilitate compliance with these new rules and assist our examination staff. Finally, the Commission is adopting amendments to the Advisers Act compliance rule, which affect all registered investment advisers, to better enable our staff to conduct examinations.

**DATES:** *Effective date:* These rules are effective November 13, 2023.

*Compliance date:* See Section IV.

*Comments due date:* Comments regarding the collection of information requirements within the meaning of the Paperwork Reduction Act of 1995 should be received on or before October 16, 2023.

**FOR FURTHER INFORMATION CONTACT:** Shane Cox, Robert Holowka, and Neema Nassiri, Senior Counsels; Tom Strumpf, Branch Chief; Adele Murray, Private Funds Attorney Fellow; Melissa Rovers Harke, Assistant Director, Investment Adviser Rulemaking Office; or Marc Mehrespand, Branch Chief, Chief Counsel’s Office, at (202) 551- 6787 or [IArules@sec.gov](mailto:IArules@sec.gov), Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-8549.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission is adopting rule 17 CFR 275.206(4)-10 (final rule 206(4)-10), 17 CFR 275.211(h)(1)-1 (final rule 211(h)(1)-1), 17 CFR 275.211(h)(1)-2 (final rule 211(h)(1)-2), 17 CFR 275.211(h)(2)-1 (final rule 211(h)(2)-1), 17 CFR 275.211(h)(2)-2 (final rule 211(h)(2)-2), and 17 CFR 275.211(h)(2)-3 (final rule 211(h)(2)-3) under the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 *et seq.*] (“Advisers Act”);<sup>1</sup> and amendments to 17 CFR 275.204-2 (final amended rule 204-2) and 17 CFR 275.206(4)-7 (final amended rule 206(4)-7) under the Advisers Act.

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## I. INTRODUCTION

The Commission oversees private fund advisers, many of which are registered with the SEC or report to the SEC as exempt reporting advisers. Despite the Commission’s examination and enforcement efforts with respect to private fund advisers, such advisers continue to engage in certain practices that may impose significant risks and harms on investors and private funds. Consequently, there is a compelling need for the Commission to exercise its congressional authority for the protection of investors.<sup>2</sup> Based on the Commission’s extensive experience overseeing private fund advisers, the Commission is adopting carefully tailored rules to address the risks and harms to investors and funds, while promoting efficiency, competition, and capital formation.<sup>3</sup>

### *Background*

Private funds are privately offered investment vehicles that pool capital from one or more investors and invest in securities and other instruments or investments.<sup>4</sup> Each investor in a

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<sup>2</sup> See *infra* section I.C.

<sup>3</sup> See *infra* section VI.E. See also Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Release No. 5955 (Feb. 9, 2022) [87 FR 16886 (Mar. 24, 2022)] (“Proposing Release”); Reopening of Comment Periods for “Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews” and “Amendments Regarding the Definition of ‘Exchange’ and Alternative Trading Systems (ATs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities,” Investment Advisers Act Release No. 6018 (May 9, 2022) [87 FR 29059 (May 12, 2022)]; Resubmission of Comments and Reopening of Comment Periods for Certain Rulemaking Releases, Investment Advisers Act Release No. 6162 (Oct. 7, 2022) [87 FR 63016 (Oct. 18, 2022)]. The Commission voted to issue the Proposing Release on Feb. 9, 2022. The release was posted on the Commission website that day, and comment letters were received beginning that same date. The comment period closed on Nov. 1, 2022. We have considered all comments received since Feb. 9, 2022.

<sup>4</sup> Section 202(a)(29) of the Advisers Act defines the term “private fund” as an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) (“Investment Company Act”), but for section 3(c)(1) or 3(c)(7) of that Act. We use “private fund” and “fund” interchangeably throughout this release. Securitized asset funds are excluded from the term “private funds” for purposes hereof, unless stated otherwise. See *infra* section II.A (Scope of Advisers Subject to the Final Private Fund Adviser Rules) for a discussion of the application of the final rules to securitized asset funds.

private fund invests by purchasing securities (which are generally issued by the fund in the form of interests or shares) and then participates in the fund through the securities that it holds.

Private funds are generally advised by investment advisers that are subject to a Federal fiduciary duty as well as the antifraud and other provisions of the Act.<sup>5</sup> A private fund adviser, which often has broad discretion to provide investment advisory services to the fund, uses the money contributed by investors to make investments on behalf of the fund.

Congress expanded the Commission's role overseeing private fund advisers and their relationship with private funds and their investors in the wake of the 2007-2008 financial crisis, when it passed, and the President signed, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). While the antifraud provisions of section 206 already applied to private fund advisers and the Commission already had brought enforcement actions against private fund advisers before the enactment of the Dodd-Frank Act, Congress increased the Commission's oversight responsibility of private fund advisers. Among other things, Congress amended the Advisers Act generally to require advisers to private funds to register with the Commission and to authorize the Commission to establish reporting and recordkeeping requirements for advisers to private funds for investor protection and systemic risk purposes.<sup>6</sup> Specifically, Title IV of the Dodd-Frank Act repealed an exemption from registration contained in section 203(b)(3) of the Advisers Act—known as the "private adviser exemption"—on which many private fund advisers, including those to private equity funds,

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<sup>5</sup> See, e.g., Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)] ("2019 IA Fiduciary Duty Interpretation").

<sup>6</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, §§ 403, 404, 124 Stat. 1378, 1571-72 (Jul. 2010), codified at 15 U.S.C. 80b-4(b).



hedge funds, and venture capital funds,<sup>7</sup> had relied.<sup>8</sup> In addition to eliminating this provision, Congress directed the Commission to adopt more limited exemptions for advisers that solely advise private funds, if the adviser has assets under management in the United States of less than \$150 million, or that solely advise venture capital funds.<sup>9</sup> Section 203(b)(3) of the Act, as amended by the Dodd-Frank Act, also provides an exemption from registration for certain foreign private advisers. As a result, private fund advisers outside of these narrow exemptions became subject to the same regulatory oversight and other Advisers Act requirements that apply to other SEC-registered investment advisers.

*Increasing Importance of Private Funds and Their Advisers to Investors*

Investment advisers' private fund assets under management have steadily increased over the past decade, growing from \$9.8 trillion in 2012 to \$26.6 trillion in 2022.<sup>10</sup> Similarly, the number of private funds has increased from 31,717 in 2012 to 100,947 in 2022.<sup>11</sup> Additionally, private funds and their advisers play an increasingly important role in the lives of millions of Americans planning for retirement.<sup>12</sup> While private funds typically issue their securities only to

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<sup>7</sup> Private equity funds, hedge funds, and venture capital funds are further described below.

<sup>8</sup> See Dodd-Frank Act, section 403.

<sup>9</sup> See Dodd-Frank Act, sections 407 and 408; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 (June 22, 2011) [76 FR 39645 (July 6, 2011)] ("Exemptions Adopting Release"). The Dodd-Frank Act also provided the Commission with the ability to require the limited number of advisers to private funds that did not have to register to file reports about their business activities.

<sup>10</sup> See Form ADV data (inclusive of assets attributable to securitized asset funds).

<sup>11</sup> *Id.* (inclusive of securitized asset funds).

<sup>12</sup> See Division of Investment Management: Analytics Office, Private Funds Statistics Report: Third Calendar Quarter 2022 (April 6, 2023) ("Form PF Statistics Report"), at 15, *available at* <https://www.sec.gov/files/investment/private-funds-statistics-2022-q3.pdf> (showing beneficial ownership of all funds by category as reported on Form PF). See also, e.g., Public Investors, Private Funds, and State Law, *Baylor Law Review*, Professor William Clayton (June 15, 2020), at 354 ("Professor Clayton Public Investors Article") (stating that public pension plans have dramatically increased their investment in private funds).

certain qualified investors, such as institutions and high net worth individuals, individuals have indirect exposure to private funds through those individuals' participation in public and private pension plans, endowments, foundations, and certain other retirement plans, which all invest directly in private funds. For example, public service workers, including law enforcement officers, firefighters, public school educators and community service workers, participate in these retirement plans and other vehicles and thus have exposure to private funds. Many pension plans, endowments, and non-profits invest in private funds to meet their internal return targets, to diversify their holdings, and to provide retirement security or other benefits for their stakeholders.<sup>13</sup> In particular, public pension plans face a stark funding gap<sup>14</sup> and many have turned to private funds in an attempt to address underfunding problems.<sup>15</sup> As a result, the 26.7 million working and retired U.S. public pension plan beneficiaries are more likely to have increased exposure to private funds.<sup>16</sup> The Commission staff have also observed a trend of rising interest in private fund investments by smaller investors with less bargaining power, such as the

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<sup>13</sup> See Form PF Statistics Report, *supra* at footnote 12. See also, e.g., Comment Letter of Healthy Markets Association (Apr. 15, 2022) ("Healthy Markets Comment Letter I") (discussing the growing number of private funds and increasing allocations that public pension plans and endowments are making to private funds); Comment Letter of Better Markets, Inc. (Apr. 25, 2022) ("Better Markets Comment Letter") (discussing the growth of the private markets and the exposure of millions of Americans to the private markets, including through pension plans). The comment letters on the Proposing Release are available at <https://www.sec.gov/comments/s7-03-22/s70322.htm>.

<sup>14</sup> States on average have less than 70% of the assets needed to fund their pension liabilities with that figure for some states reaching as low as 34%. See, e.g., Professor Clayton Public Investors Article, *supra* footnote 12; Sarah Krouse, *The Pension Hole for U.S. Cities and States is the Size of Germany's Economy*, Wall Street J. (July 30, 2018), available at <https://www.wsj.com/articles/the-pension-hole-for-u-s-cities-and-states-is-the-size-of-japans-economy-1532972501>; PEW CHARITABLE TRUSTS, ISSUE BRIEF, THE STATE PENSION FUNDING GAP: 2017 (June 27, 2019), available at <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/06/the-state-pension-funding-gap-2017>.

<sup>15</sup> See, e.g., Healthy Markets Comment Letter I; UBS Wealth Management USA, US Economy: Public Pension Plans Tilt Toward Alternatives (Jan. 12, 2023), available at <https://www.ubs.com/us/en/wealth-management/insights/market-news/article.1582725.html> (discussing State and local pension funds' increasing allocation to private funds over last two decades).

<sup>16</sup> See *National Data*, Public Plans Data, available at <https://publicplansdata.org/quick-facts/national/#:~:text=Collectively%2C%20these%20plans%20have%3A,members%20and%2011.7%20million%20retirees.>

growth of new platforms to facilitate individual access to private investments with small investment sizes, or non-institutional investor groups pooling funds to invest in private funds, or other means by which smaller individual investors can access private investments.<sup>17</sup>

#### *Role of Investment Advisers in Private Fund Structure and Organization*

While there are many different ways that private funds are structured and organized, private funds typically rely on an investment adviser (or affiliated entities, such as the fund's general partner or managing member) to provide management, investment, and other services, and such person usually has delegated authority to take actions on behalf of the private fund without the consent or approval of any other person. A private fund rarely has employees of its own—its officers, if any, are usually employed by the private fund's adviser. As a result, it is the adviser or its affiliated entities who generally draft the private fund's private placement memorandum and governing documents,<sup>18</sup> negotiate fund terms with the private fund investors, select and execute investments, charge or allocate fees and expenses to the private fund, and provide information on the private fund's activities and performance to private fund investors. Advisers are also often involved in marketing the private fund to prospective investors, including marketing to current investors in other private funds managed by the adviser.

Investors in a private fund generally pay both fees and expenses to the private fund adviser and/or its related persons. Investors typically, directly or indirectly through the fund interests they hold, pay management fees *and* performance-based compensation to the adviser of the private fund or the adviser's related person (*e.g.*, a general partner or managing member). Additionally, investors directly or indirectly bear the fees and expenses associated with the fund

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<sup>17</sup> See *infra* section VI.C.1.

<sup>18</sup> Including the private fund operating agreement to which the adviser or its affiliate and the private fund investors are typically both parties.

and the fund's investments. It is also not uncommon for a private fund's underlying portfolio investments to pay the adviser (or a related person) monitoring, transaction or other fees and expenses, which can be, but are not always, offset against the management fees paid to the adviser.<sup>19</sup> In certain cases, advisers also negotiate with investors to have investors pay certain of the adviser's own expenses (such as certain compliance costs of the adviser).

There are many different types of private funds. Two broad categories of private funds are hedge funds and private equity funds. Hedge funds tend to invest in more liquid assets and generally allow investors the opportunity to voluntarily withdraw their interests with certain limitations, including for example, restrictions on timing and notice requirements and, for certain funds, the amount that can be redeemed at one time or over a period of time. Private equity funds, on the other hand, tend to invest in illiquid assets and generally do not permit investors to voluntarily withdraw their interests in the fund. Hedge funds engage in trillions of dollars in listed equity and futures transactions each month,<sup>20</sup> while private equity funds tend to focus on private investments, whether through mergers and acquisitions, non-bank lending, restructurings, and other transactions. Hedge funds have over nine trillion dollars in gross asset value and private equity funds have over six trillion.<sup>21</sup> Beyond hedge funds and private equity funds, there are other categories of private funds, some of which overlap with these two. For example, venture capital funds are in many ways structurally similar to private equity funds and provide funding to start-up and early-stage companies. As another example, real estate private funds

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<sup>19</sup> Compensation at the underlying "portfolio investment-level" is more common for certain private funds, such as private equity, venture capital or real estate funds, and less common for others, such as hedge funds.

<sup>20</sup> See Form PF Statistics Report, *supra* at footnote 12, at 31 (showing aggregate portfolio turnover for hedge funds managed by large hedge fund advisers (*i.e.*, advisers with at least \$1.5 billion in hedge fund assets under management) as reported on Form PF).

<sup>21</sup> See *id.*

generally invest in illiquid real estate assets, and as such typically do not permit investors to withdraw their interests in the fund voluntarily. Venture capital and real estate private funds have over one trillion dollars in gross asset value.<sup>22</sup>

### *Need for Further Commission Oversight*

With over a decade since the Dodd-Frank Act required private fund advisers to register with us, the Commission now has extensive experience in overseeing and regulating private fund advisers. Form ADV and Form PF reporting have been critical to improving our ability to understand private fund advisers' operations and relationships with funds and investors as private funds continue growing in size, complexity, and number.<sup>23</sup> The information from these forms has enabled us to enhance our assessment of private fund advisers for purposes of targeting examinations and responding to emerging trends. For example, the Commission's Division of Examinations stated in its 2023 examination priorities that it will continue to focus on registered private fund advisers, including such advisers' conflicts of interest and calculations and allocations of fees and expenses.<sup>24</sup> This information has also improved our ability to identify practices that could harm private fund investors and has helped us not only promote compliance but also detect, investigate, and deter fraud and other misconduct.

In the course of this oversight of private fund advisers, we have observed three primary factors that contribute to investor protection risks and harms: lack of transparency, conflicts of

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<sup>22</sup> See *id.* See *infra* section II.A (Scope of Advisers Subject to the Final Private Fund Adviser Rules) for a discussion of securitized asset funds as well.

<sup>23</sup> Form ADV has also increased transparency to investors.

<sup>24</sup> See Securities and Exchange Commission's Division of Examinations 2023 Examination Priorities (Feb. 7, 2023), available at <https://www.sec.gov/files/2023-exam-priorities.pdf>.

interest, and lack of governance mechanisms.<sup>25</sup> We have observed that these three factors contribute to significant investor harm, such as an adviser incorrectly, or improperly, charging fees and expenses to the private fund, contrary to the adviser’s fiduciary duty, contractual obligations to the fund, or disclosures by the adviser.<sup>26</sup> The Commission has pursued enforcement actions against private fund advisers for fraudulent practices related to fee and expense charges or allocations that are influenced by the advisers’ conflicts of interest.<sup>27</sup> For example, the Commission has brought a settled action alleging private fund advisers misallocated more than \$17 million in so-called “broken deal” expenses to an adviser’s flagship private equity fund<sup>28</sup> and improperly allocated approximately \$2 million of compensation-related expenses to three private equity funds that an adviser managed.<sup>29</sup> Our staff has examined private fund advisers to assess both the issues and risks presented by their business models and the firms’ compliance with their existing legal obligations. Despite these enforcement and

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<sup>25</sup> To the extent that these issues negatively affect the efficiency with which investors search for and match with advisers, the alignment of investor and adviser interests, investor confidence in private fund markets, or competition between advisers, then the final rules may improve efficiency, competition, and capital formation in addition to benefiting investors. *See infra* sections VI.B, VI.E. *See, e.g.*, Comment Letter of Consumer Federation of America (Apr. 25, 2022) (“Consumer Federation of America Comment Letter”).

<sup>26</sup> *See, e.g., In the Matter of Blackstone Management Partners, L.L.C., et. al.*, Investment Advisers Act Release No. 4219 (Oct. 7, 2015) (settled action) (alleging that the adviser received undisclosed fees) (“In the Matter of Blackstone”); *In the Matter of Lincolnshire Management, Inc.*, Investment Advisers Act Release No. 3927 (Sept. 22, 2014) (settled action) (alleging that the adviser misallocated fees and expenses among private fund clients) (“In the Matter of Lincolnshire”); *In the Matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC*, Investment Advisers Act Release No. 4258 (Nov. 5, 2015) (settled action) (alleging that the adviser improperly shifted expenses related to an examination and an investigation away from itself).

<sup>27</sup> *Id.*

<sup>28</sup> *See In the Matter of re Kohlberg Kravis Roberts & Co. L.P.*, Investment Advisers Act Release No. 4131 (June 29, 2015) (settled action) (“In the Matter of Kohlberg Kravis Roberts & Co.”).

<sup>29</sup> *See In re NB Alternatives Advisers LLC*, Investment Advisers Act Release No. 5079 (Dec. 17, 2018) (settled action) (“In the Matter of NB Alternatives Advisers”).

examination efforts, problematic practices persist.<sup>30</sup> For example, the Commission has brought charges against private fund advisers for failing to disclose material conflicts of interest to a private fund that an adviser managed as well as misleading its investors by misrepresenting an investment opportunity,<sup>31</sup> and for failing to disclose to investors that the adviser periodically made loans to a company owned by the son of the principal of the advisory firm and that the private fund's investment in the company could be used to repay the loans made by the adviser.<sup>32</sup> Additionally, any risks and harms imposed by private fund advisers on private funds and their investors indirectly expose the investors' individual stakeholders and beneficiaries (e.g., public service workers, law enforcement officers, firefighters, public school educators, and community service workers) to the same risks and harms.

Accordingly, we proposed a series of new rules under the Advisers Act to protect investors, promote more efficient capital markets, and encourage capital formation.<sup>33</sup> After considering comments, the Commission is adopting rules with modifications that make the rules less restrictive and more flexible, while still providing investors with the protections to which

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<sup>30</sup> See, e.g., *In re Global Infrastructure Management, LLC*, Investment Advisers Act Release No. 5930 (Dec. 20, 2021) (settled action) (alleging private fund adviser failed to properly offset management fees to private equity funds it managed and made false and misleading statements to investors and potential investors in those funds concerning management fee offsets); *In the Matter of EDG Management Company, LLC*, Investment Advisers Act Release No. 5617 (Oct. 22, 2020) (settled action) (alleging that private equity fund adviser failed to apply the management fee calculation method specified in the limited partnership agreement by failing to account for write downs of portfolio securities causing the fund and investors to overpay management fees); *In the Matter of Energy Capital Partners Management, LP*, Investment Advisers Act Release No. 6049 (June 15, 2022) (settled action) (alleging that the adviser allocated undisclosed and disproportionate expenses to a private fund client) ("In the Matter of Energy Capital Partners"); *In the Matter of Insight Venture Management, LLC*, Investment Advisers Act Release No. 6322 (June 20, 2023) (settled action) (alleging that the adviser failed to disclose a conflict of interest relating to its fee calculations and overcharged management fees) ("In the Matter of Insight").

<sup>31</sup> See *In the Matter of Mitchell J. Friedman*, Investment Advisers Act Release No. 5338 (Sept. 4, 2019) (settled action).

<sup>32</sup> See *In the Matter of Diastole Wealth Management, Inc.*, Investment Advisers Act Release No. 5855 (Sept. 10, 2021) (settled action).

<sup>33</sup> See Proposing Release, *supra* footnote 3.

they are entitled. The adopted rules will help address risks and harms to investors in a carefully tailored way that promotes efficiency, competition, and capital formation, as well as investor protection.

#### **A. Risks and Harms to Investors**

These rules and amendments are important enhancements to private fund adviser regulation because they protect the adviser's private fund clients and those who invest in private funds by increasing visibility into certain activities, curbing practices that lead to harm to funds and their investors, and restricting adviser activity that is contrary to the public interest and the protection of investors. The private fund adviser reforms are designed specifically to address the following three factors for risks and harms that are common in an adviser's relationship with private funds and their investors: lack of transparency, conflicts of interest, and lack of effective governance mechanisms for client disclosure, consent, and oversight.

**Lack of Transparency.** Private fund investments are often opaque, and advisers do not frequently or consistently provide investors with sufficiently detailed information about the terms of the advisers' relationships with funds and their investors. For example, there are no specific requirements for the information that private fund advisers must disclose to private fund investors about the funds' investments, performance, or incurred fees and expenses, notwithstanding the applicability of the antifraud provisions of the federal securities laws and any relevant requirements of the marketing rule and private placement rules. Rather, information and disclosure about these items and the terms of an investment in a private fund are generally individually negotiated between private fund investors and the fund's adviser. Since private fund structures can be complex and involve multiple entities that are related to, or otherwise affiliated with, the adviser, absent specifically negotiated disclosure, it may be difficult for investors to



understand the conflicts embedded within these structures and the overall compensation received by the adviser. Without specific information, even sophisticated investors cannot understand the fees and expenses they are paying, the risks they are assuming, and the performance they are achieving in return.<sup>34</sup> Investors have received reduced returns due to improperly charged fees and expenses,<sup>35</sup> and they must sometimes choose between expending resources to negotiate for detailed fee and expense or performance reporting or using their bargaining power to improve the economic, informational, or governance terms of the investors' relationships with funds and their advisers.<sup>36</sup>

**Conflicts of Interest.** These rules address many of the problems raised by the conflicts of interest commonly present in private fund adviser practices. Conflicts of interest can harm investors, such as when an adviser grants preferential redemption rights to entice a large investor that will increase overall management fees to commit to a private fund, and then, when the fund experiences a decline, such preferential redemption rights allow a large investor to exit the private fund before and on more advantageous terms than other investors. Investors are also harmed by not being informed of conflicts of interest concerning the private fund adviser and the fund, which reduces the information available to investors to guide their investment decisions.<sup>37</sup> There is a trend of rising interest in private funds by smaller investors with less bargaining power, who may be particularly impacted by these practices, including where advisers grant

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<sup>34</sup> See, e.g., *In the Matter of Insight*, *supra* footnote 30 (alleging that, due to lack of disclosure, investors were unaware of the extent of the conflict of interest associated with an adviser's permanent impairment criteria and that the adviser charged excessive management fees).

<sup>35</sup> See *infra* section II.B.

<sup>36</sup> See, e.g., Comment Letter of Ohio Public Employees Retirement System (Apr. 25, 2022) ("OPERS Comment Letter"); Comment Letter of Institutional Limited Partners Association (Apr. 25, 2022) ("ILPA Comment Letter I").

<sup>37</sup> See, e.g., *In the Matter of Insight*, *supra* footnote 30 (alleging that the adviser charged excess management fees and failed to disclose a conflict of interest to investors relating to its fee calculations).

preferential terms to larger investors that may exacerbate conflicts of interest as well as the risks of resulting investor harm.<sup>38</sup>

Certain conflicts of interest between advisers and private funds also involve sales practices or compensation schemes that are problematic for investors. For example, advisers have a conflict of interest with private funds (and, indirectly, investors in those funds) when they value the fund's assets and use that valuation as the basis for the calculation of the adviser's fees and fund performance. Similarly, advisers have a conflict of interest with the fund (and, indirectly, its investors) when they offer existing fund investors the choice between selling and exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons as part of an adviser-led secondary transaction.<sup>39</sup> In both of these examples, there are opportunities for advisers, funds, and investors to benefit, but there is also a potential for significant harm if the adviser's conflicts are not managed appropriately, including diminishing the fund's returns because of excess fees and expenses paid to the fund's adviser or its related persons.

**Lack of Governance Mechanisms.** These rules are designed to respond to harms arising out of private fund governance structures. In a typical private fund structure, the private fund is the adviser's client and investors in the private fund are not clients of the adviser (unless investors have a separate advisory relationship with the adviser in addition to their investment in the private fund). The adviser (or its related person) commonly serves as the general partner or

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<sup>38</sup> See *infra* sections VI.B, VI.C.1.

<sup>39</sup> Emerging Trends in the Evolving Continuation Fund Market, Private Equity Law Report (July 2022), available at <https://www.pelawreport.com/19285026/emerging-trends-in-the-evolving-continuation-fund-market.html> (stating that the market volume for private fund secondaries increased from \$37 billion in 2016 to \$132 billion in 2021 and that "much of that growth was driven by an explosion in GP-led continuation fund activity").

managing member (or similar control person) of the fund. Because the adviser (or its related person) acts on behalf of the fund client and is typically not required to obtain the input or consent of investors in the fund, the governance structure of a typical private fund is not designed to prioritize investor oversight of the adviser and general partner or managing member (or similar control person) or investor policing of conflicts of interest.

For example, although some private funds may have limited partner advisory committees (“LPACs”) or boards of directors, these types of bodies may not have sufficient independence, authority, or accountability to oversee and consent to these conflicts.<sup>40</sup> Such LPACs or boards of directors do not have a fiduciary obligation to the private fund investors. Moreover, private fund advisers often provide certain investors with preferential terms, such as representation in an LPAC, that can create potential conflicts among the fund’s investors. The interests of one or more private fund investors may not represent the interests of, or may otherwise conflict with the interests of, other investors in the private fund due to, among other things, business or personal relationships or other private fund investments. To the extent investors are afforded LPAC representation or similar rights, certain fund agreements may permit such investors to exercise their rights in a manner that places their interests ahead of the private fund or the investors as a whole. For example, certain fund agreements state that, subject to applicable law, LPAC members owe no duties to the private fund or to any of the other investors in the private fund and are not obligated to act in the interests of the private fund or the other investors as a whole.

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<sup>40</sup> A fund’s LPAC or board typically acts as the decision-making body with respect to conflicts that may arise between the interests of the third-party investors and the interests of the adviser. In certain cases, advisers seek the consent of the LPAC or board for conflicted transactions, such as transactions involving investments in portfolio companies of related funds or where the adviser seeks to cause the fund to engage a service provider that is affiliated with the adviser.

The rules we are adopting are designed to protect private fund investors by addressing private fund advisers’ conflicts of interest, sales practices, and compensation schemes. Such protection is necessary because investors face difficulties in negotiating for reformed practices, including stronger governance structures, because of the bargaining power held by advisers and by investors who benefit from current adviser practices, such as investors who receive preferential treatment from their advisers.<sup>41</sup> In addition, as discussed above, the indirect exposure of the general public to the risks of private fund investments heightens the need for specific rulemaking to address these concerns.

## **B. Rules to Address These Risks and Harms**

The Commission proposed rules to address the risks and harms to investors and funds, and we received many comment letters on the proposal.<sup>42</sup> A number of commenters supported the proposal and stated that it would have an overall positive impact on the industry.<sup>43</sup> Some commenters stated that it would establish baseline protections for investors, such as increased transparency and standardized reporting.<sup>44</sup> Other commenters expressed frustration with the conflicts of interest in the private funds industry<sup>45</sup> and supported prohibitions on certain unfair

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<sup>41</sup> See *infra* section VI.B.

<sup>42</sup> See Proposing Release, *supra* footnote 3.

<sup>43</sup> See, e.g., Comment Letter of United for Respect (Apr. 12, 2022) (“United for Respect Comment Letter I”); Comment Letter of Private Equity Stakeholder Project (Apr. 25, 2022); Comment Letter of Trine Acquisition Corp. (Apr. 21, 2022) (“Trine Comment Letter”).

<sup>44</sup> See, e.g., Comment Letter of InvestX (Mar. 18, 2022) (“InvestX Comment Letter”); Comment Letter of American Association for Justice (Apr. 25, 2022) (“American Association for Justice Comment Letter”); OPERS Comment Letter.

<sup>45</sup> See, e.g., Comment Letter of Public Citizen (Apr. 15, 2022) (“Public Citizen Comment Letter”); Comment Letter of the Comptroller of the State of New York (Apr. 25, 2022) (“NY State Comptroller Comment Letter”); Comment Letter of Comptroller of the City of New York (Apr. 21, 2022) (“NYC Comptroller Comment Letter”).

practices.<sup>46</sup> One commenter stated that the rules, if adopted, “would implement a variety of essential improvements in the regulation of the private funds markets, making this increasingly important financial sector substantially more fair and transparent.”<sup>47</sup> Another commenter stated that the proposed rules are essential to protect the right of investors to access information critical to making informed investment decisions, especially because private market investments will likely play an increasingly growing role in the asset allocations and funding targets of institutional investors.<sup>48</sup> In contrast, other commenters opposed the proposal and expressed concern that it would negatively impact the industry by stifling capital formation and reducing competition.<sup>49</sup> Certain commenters asserted that the proposed requirements would overburden advisers (especially smaller advisers) with compliance costs, which may ultimately be passed on to investors, directly or indirectly.<sup>50</sup> These and other comments are discussed more fully below. The final rules include modifications in response to concerns raised and provide additional flexibility and tailoring to the rules as proposed, while preserving the needed investor protections.

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<sup>46</sup> See, e.g., Comment Letter of General Treasurer of Rhode Island, For the Long Term and Illinois State Treasury, For the Long Term (June 13, 2022) (“For the Long Term Comment Letter”); Comment Letter of the Regulatory Fundamentals Group (Apr. 25, 2022) (“RFG Comment Letter II”); United for Respect Comment Letter I.

<sup>47</sup> See Better Markets Comment Letter.

<sup>48</sup> See Comment Letter of District of Columbia Retirement Board (Apr. 22, 2022) (“DC Retirement Board Comment Letter”).

<sup>49</sup> See, e.g., Comment Letter of the Private Investment Funds Forum (Apr. 25, 2022) (“PIFF Comment Letter”); Comment Letter of the Alternative Investment Management Association Limited and the Alternative Credit Council (Apr. 25, 2022) (“AIMA/ACC Comment Letter”); Comment Letter of the Securities Industry and Financial Markets Association Asset Management Group (Apr. 25, 2022) (“SIFMA-AMG Comment Letter I”).

<sup>50</sup> See, e.g., Comment Letter of Lockstep Ventures (Apr. 26, 2022) (“Lockstep Ventures Comment Letter”); Comment Letter of Thin Line Capital (Apr. 21, 2022) (“Thin Line Capital Comment Letter”); Comment Letter of Blended Impact (Apr. 24, 2022) (“Blended Impact Comment Letter”).

**The Quarterly Statement Rule.** The Commission proposed a rule to require SEC-registered advisers to private funds to provide investors with periodic information about private fund fees, expenses, and performance.<sup>51</sup> The Commission is adopting the rule with changes in response to comments:<sup>52</sup>

- Advisers to illiquid funds are required to calculate performance information with and without the impact of subscription facilities, rather than only without;
- We have refined the definition of illiquid fund to be based primarily on withdrawal and redemption capability;
- Instead of requiring advisers to present liquid fund performance since inception, we are only requiring a 10-year lookback; and
- We are allowing additional time for delivery of fourth quarter statements and additional time for delivery of all statements for funds of funds.

As discussed more fully below, we are adopting the quarterly statement rule because we see this lack of transparency in many areas, including investment advisers' disclosure regarding private fund fees, expenses, and performance. For example, some private fund investors do not have sufficient information regarding private fund fees and expenses because those fees and expenses have varied labels across private funds and are subject to complicated calculation methodologies.<sup>53</sup> Increased transparency on fees can also help address conflicts of interest concerns. For example, some private fund advisers and their related persons charge a number of fees and expenses to the fund's portfolio companies, and it may be difficult for investors to track

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<sup>51</sup> See *infra* section II.B for a discussion of the comments on this aspect of the rule.

<sup>52</sup> The final quarterly statement, audit, adviser-led secondaries, restricted activities, and preferential treatment rules do not apply to investment advisers with respect to securitized asset funds they advise. See *infra* section II.A (Scope of Advisers Subject to the Final Private Fund Adviser Rules).

<sup>53</sup> See Proposing Release, *supra* footnote 3, at section I.

fee streams that flow to the adviser or its related persons and reduce the return on their investment.

Investors will also benefit from increased transparency into how private fund performance is calculated. Currently, private fund advisers use different metrics and specifications for calculating performance, which makes it difficult for investors to compare data across funds and advisers, even when advisers disclose the assumptions they used. More standardized requirements for performance metrics will allow private fund investors to compare more effectively the returns of similar fund strategies over different market environments and over time. In addition, they would improve investors' ability to interpret complex performance reporting and assess the relationship between the fees paid in connection with an investment and the return on that investment as they monitor their investment and consider potential future investments.

**The Audit Rule.** The Commission is adopting the requirement that an SEC-registered adviser cause each private fund that it advises to undergo an annual audit; however, in a change from the proposal, we are requiring the audit to comply with the audit provision under 17 CFR 275.206(4)-2 of the Advisers Act ("rule 206(4)-2" "custody rule").<sup>54</sup> To address the valuation concerns described above and more fully below,<sup>55</sup> we are requiring SEC-registered advisers to cause the private funds they manage to obtain an annual audit. By addressing the concerns that arise in the valuation process, the rule will help prevent fraud and deception by the adviser.

**The Adviser-led Secondaries Rule.** The final rule will require SEC-registered advisers conducting an adviser-led secondary transaction to satisfy certain requirements; however, in a

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<sup>54</sup> See *infra* section II.C for a discussion of the comments on this part of the rule.

<sup>55</sup> See *infra* section II.C.

change from the proposal, advisers may obtain a fairness opinion *or* a valuation opinion under the final rule.<sup>56</sup> SEC-registered advisers conducting an adviser-led secondary transaction must also prepare and distribute a written summary of any material business relationships between the adviser or its related persons and the independent opinion provider. By requiring that investors receive a third-party opinion and a written summary of any material business relationships before deciding whether to participate in an adviser-led secondary transaction, the final rule will help prevent investors from being defrauded, manipulated, and deceived when the adviser is on both sides of the transaction.

**The Restricted Activities Rule.** The final rule will address concerns about five activities with respect to private fund advisers.<sup>57</sup> In a change from the proposal, while the restricted activities rule (referred to as the prohibited activities rule in the proposal) prohibits advisers from engaging in certain activity, the final rule includes certain disclosure-, and in some cases, consent-based exceptions. As a result, advisers generally are not flatly prohibited from engaging in the following activities,<sup>58</sup> so long as they provide appropriate specified disclosure and, in some cases, obtain investor consent:

- Charging or allocating to the private fund fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority; however, regardless of any disclosure or consent, an adviser

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<sup>56</sup> See *infra* section II.C.8 for a discussion of the comments on this part of the rule.

<sup>57</sup> See *infra* sections II.E and II.F for a discussion of the comments on this part of the rule.

<sup>58</sup> As discussed in greater detail below, this does not change the applicability of any other disclosure and consent obligations, whether under law, rule, regulation, contract, or otherwise. For example, the adviser, as a fiduciary, is obligated to act in the fund's best interest and to make full and fair disclosure of all conflicts and material facts which might incline an investment adviser – consciously or unconsciously – to render advice which is not disinterested such that a client can provide informed consent to the conflict. See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5.



may not charge or allocate fees and expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for violating the Investment Advisers Act of 1940 or the rules promulgated thereunder;

- Charging or allocating to the private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the adviser or its related persons;
- Reducing the amount of an adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders;
- Charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment, where such non-pro rata allocation is fair and equitable; and
- Borrowing money, securities, or other private fund assets, or receiving a loan or an extension of credit, from a private fund client.

In a change from the proposal, we are not adopting the prohibition on fees for unperformed services because we believe this activity generally already runs contrary to an adviser's obligations to its clients under the Federal fiduciary duty. We are also not adopting the indemnification prohibition that we proposed because much of the activity that it would have prohibited is already prohibited by the Federal fiduciary duty and antifraud provisions.

**The Preferential Treatment Rule.** The Commission is adopting a preferential treatment

rule that prohibits advisers from providing preferential treatment with respect to redemption rights and portfolio holdings or exposure information, in each instance, that the adviser reasonably expects would have a material, negative effect on other investors, and requires disclosure of all other types of preferential treatment.<sup>59</sup> In a change from the proposal, the final rule includes certain exceptions from the redemptions prohibition (*i.e.*, if the redemption right is required by law or offered to all other existing investors) and information prohibition (*i.e.*, if the information is offered to all other existing investors) and limits the proposed requirement to provide advance written notice of preferential treatment to only apply to material economic terms (as opposed to all investment terms). Like the proposal, however, the final rule requires advisers to provide comprehensive post-investment disclosure.

We are also adopting the preferential treatment rule, in part, because all investors will benefit from increased transparency regarding the preferred terms granted to certain investors in the same private fund (*e.g.*, seed investors, strategic investors, those with large commitments, and employees, friends, and family). In some cases, these terms materially disadvantage other investors in the private fund or otherwise impact the terms applicable to their investment.<sup>60</sup> This new rule will help investors better understand marketplace dynamics and potentially improve efficiency for future investments, for example, by expediting the process for reviewing and negotiating adviser's fees and expenses.

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<sup>59</sup> See *infra* section II.G for a discussion of the comments on this part of the rule.

<sup>60</sup> See, *e.g.*, *Securities and Exchange Commission v. Philip A. Falcone, Harbinger Capital Partners Offshore Manager, L.L.C. and Harbinger Capital Partners Special Situations GP, L.L.C.*, Civil Action No. 12 Civ. 5027 (PAC) (S.D.N.Y.) and *Securities and Exchange Commission v. and (sic) Harbinger Capital Partners LLC, Philip A. Falcone and Peter A. Jenson*, Civil Action No. 12 Civ. 5028 (PAC) (S.D.N.Y.), Civil Action No. 12 Civ. 5027 (PAC) (S.D.N.Y.), U.S. Securities and Exchange Commission Litigation Release No. 22831A (Oct. 2, 2013) (“Harbinger Capital”) (private fund adviser granted favorable redemption and liquidity terms to certain large investors in a private fund without disclosing these arrangements to the fund’s board of directors and the other fund investors). See also 17 CFR 275.206(4)-8 (rule 206(4)-8 under the Advisers Act).

**The Annual Review Rule.** As proposed, the final rule will amend the annual review component of Advisers Act rule 206(4)-7 (“compliance rule”) to require all SEC-registered advisers to document their annual review in writing, and we are adopting this rule as proposed.<sup>61</sup> We are adopting this requirement for two key reasons. First, written documentation of the annual review may help advisers better assess whether they have considered any compliance matters that arose during the previous year, any changes in the adviser’s or an affiliate’s business activities during the year, and any changes to the Advisers Act or other rules and regulations that may suggest a need to revise an adviser’s policies and procedures. Second, the availability of written documentation of the annual review should allow the Commission and the Commission staff to determine if the adviser is regularly reviewing the adequacy of the adviser’s policies and procedures.

**The Recordkeeping Rule.** As proposed, the final rule will amend the Advisers Act recordkeeping rule to require advisers who are registered or required to be registered to retain books and records related to the quarterly statement rule, the audit rule, the adviser-led secondaries rule, and the preferential treatment rule.<sup>62</sup> In a change from the proposal, we are also amending the Advisers Act recordkeeping rule to require advisers who are registered or required to be registered to retain books and records related to the restricted activities rule.<sup>63</sup> We are adopting these requirements to enhance advisers’ internal compliance efforts and to facilitate the Commission’s enforcement and examination capabilities by improving our staff’s ability to assess an adviser’s compliance with the final rule.

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<sup>61</sup> See *infra* section III for a discussion of the comments on this part of the rule.

<sup>62</sup> See *infra* sections II.B.6, II.C.8, II.D.5, and II.G.6 for discussions of the comments on this part of the rule.

<sup>63</sup> The recordkeeping requirements associated with the restricted activities rule align with the modifications from the prohibited activities rule in the proposal. See *infra* section II.E for a discussion of the comments on this part of the rule.

### C. The Commission Has Authority to Adopt the Rules

The Commission regulates investment advisers under the Advisers Act.<sup>64</sup> For the reasons we discussed in the Proposing Release and throughout this release, our adoption of these private fund adviser rules is a proper exercise of our rulemaking authority under the Advisers Act to prevent fraudulent, deceptive, and manipulative conduct, facilitate the provision of simple and clear disclosures to investors, and prohibit or restrict certain sales practices, conflicts of interest, and compensation schemes.<sup>65</sup>

We have authority under section 206(4) to adopt rules “reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative.”<sup>66</sup> Among other things, section 206(4) permits the Commission to adopt prophylactic rules against conduct that is not itself necessarily fraudulent.<sup>67</sup> The Dodd-Frank Act expanded the

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<sup>64</sup> Under Federal law, an investment adviser is a fiduciary, and this fiduciary duty is made enforceable by the antifraud provisions of the Advisers Act. *See* 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5.

<sup>65</sup> *See* Advisers Act, sections 206 and 211(h).

<sup>66</sup> 15 U.S.C. 80b-6(4).

<sup>67</sup> S. REP. NO. 1760, 86<sup>th</sup> Cong., 2d Sess. 4, 8 (1960). The Commission has used this authority to adopt several rules addressing abusive marketing practices, political contributions by investment advisers, proxy voting, compliance procedures and practices, deterring fraud with respect to pooled investment vehicles, and custodial arrangements including an audit provision. Rule 206(4)-1; 275.206(4)-2; 275.206(4)-6; 275.206(4)-7; and 275.206(4)-8. Section 206(4) was added to the Advisers Act in Pub. L. No. 86-750, 74 Stat. 885, at sec. 9 (1960). *See* H.R. REP. NO. 2197, 86<sup>th</sup> Cong., 2d Sess., at 7-8 (1960) (“Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit . . . [Section 206(4)] would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of business which are fraudulent, deceptive, or manipulative. This is comparable to Section 15(c)(2) of the Securities Exchange Act [15 U.S.C. 78o(c)(2)] which applies to brokers and dealers.”). *See also* S. REP. NO. 1760, 86<sup>th</sup> Cong., 2d Sess., at 8 (1960) (“This [section 206(4) language] is almost the identical wording of section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers.”). The Supreme Court, in *United States v. O’Hagan*, interpreted nearly identical language in section 14(e) of the Securities Exchange Act [15 U.S.C. 78n(e)] as providing the Commission with authority to adopt rules that are “definitional and prophylactic” and that may prohibit acts that are “not themselves fraudulent . . . if the prohibition is ‘reasonably designed to prevent . . . acts and practices [that] are fraudulent.’” *United States v. O’Hagan*, 521 U.S. 642, 667, 673 (1997). The wording of the rulemaking authority in section 206(4) remains substantially similar to that of section 14(e) and section 15(c)(2) of the Securities Exchange Act. *See also* Prohibition of Fraud by

Commission’s oversight responsibility for private fund advisers.<sup>68</sup> It also added section 211(h) of the Advisers Act, which, among other things, directs the Commission to “facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with...investment advisers” and “examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.”<sup>69</sup> As applied here, a sales practice includes any conduct by an investment adviser, or on its behalf, to induce or solicit a person to invest, or continue to invest, in a private fund client advised by the adviser or its related persons. For instance, an adviser offering preferential terms to certain private fund investors to attract, or retain, their investment in the private fund is a “sales practice.” As the Commission has previously stated, a conflict of interest means an interest that might incline an adviser, consciously or unconsciously, to render advice that is not disinterested.<sup>70</sup> Conflicts of interest can arise when an adviser’s own interests conflict with, or are otherwise different than, its client’s interests or when the interests of different clients conflict.<sup>71</sup> For instance, an adviser has a conflict of interest in an adviser-led secondary transaction because the adviser and its related persons typically are involved on both sides of the transaction. As applied here, a compensation scheme includes any arrangement

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Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)] (“Prohibition of Fraud Adopting Release”) (stating, in connection with the suggestion by commenters that section 206(4) provides us authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under a particular rule, “We believe our authority is broader. We do not believe that the commenters’ suggested approach would be consistent with the purposes of the Advisers Act or the protection of investors.”).

<sup>68</sup> See the discussion of the Dodd-Frank Act above in the introductory portion of section I.

<sup>69</sup> Dodd-Frank Act, section 913(g).

<sup>70</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at 23.

<sup>71</sup> See *id.*, at 26.

through which an investment adviser is compensated—directly or indirectly—for providing services to its clients (*e.g.*, performance-based compensation). An example of a problematic compensation scheme is when an adviser opportunistically values a private fund to increase the adviser’s compensation.

Sections 206(4) and 211(h) of the Advisers Act are the principal authority for all of the five new rules to regulate the activities of investment advisers to private funds. The new rules are within the Commission’s legal authority under those sections of the Advisers Act as a means reasonably designed to prevent fraudulent or deceptive acts and practices, facilitate simple and clear disclosures to investors, and prohibit or restrict certain sales practices, conflicts of interest, and compensation schemes in the market for advisory services to private funds. The quarterly statement rule is designed to facilitate the provision of simple and clear disclosures to private fund investors regarding some of the most important and fundamental terms of their relationships with investment advisers—namely what fees and expenses those investors will pay and what performance they receive for their private fund investments. The audit rule is designed to help prevent the fraud, deception, or manipulation that might result from material misstatements in financial statements, and it is intended to address the conflicts of interest and potential compensation schemes that may result from an adviser valuing assets and charging fees related to those assets. When advisers offer investors the choice between selling and exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons as part of an adviser-led secondary transaction, advisers have a conflict of interest with the fund and its investors, and the adviser-led secondaries rule is designed to address this concern. The restricted activities rule is designed to prohibit certain activities that involve conflicts of interest and compensation schemes that are contrary to the public interest

and the protection of investors unless such activities are disclosed to, and in some cases, consented to, by investors. Finally, the preferential treatment rule addresses our concern that an adviser’s current sales practices do not provide all investors with sufficient detail regarding preferential terms granted to other investors, and we believe that disclosure (and in some cases prohibition) of preferential treatment is necessary to guard against fraudulent and deceptive practices. We have examined a range of alternatives to our proposal, carefully considered all comments, and made revisions to the proposed rules where we concluded it was appropriate. The final rules represent an appropriate response to the developments we discuss above regarding the market for private fund advisory services.

Some commenters supported the Commission’s legal foundation for the rulemaking.<sup>72</sup> For example, one commenter stated that all of the reforms in the proposal are fully within the Commission’s ample legal authority to regulate advisers.<sup>73</sup> Another commenter emphasized that, importantly, the Commission’s legal authority under section 211(h) is broad.<sup>74</sup> Other commenters, however, questioned the Commission’s authority to promulgate the proposed rules<sup>75</sup> and argued that the rules undermine congressional intent regarding the regulation of private funds.<sup>76</sup> Some commenters argued that Congress, in drafting section 913(g) of the Dodd-

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<sup>72</sup> See, e.g., Consumer Federation of America Comment Letter; Better Markets Comment Letter.

<sup>73</sup> See Better Markets Comment Letter.

<sup>74</sup> See Consumer Federation of America Comment Letter.

<sup>75</sup> See, e.g., Comment Letter of Stuart Kaswell (Apr. 18, 2022) (“Stuart Kaswell Comment Letter”); Comment Letter of the Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (Apr. 25, 2022) (Chamber of Commerce Comment Letter”); Comment Letter of the Managed Funds Association (Apr. 25, 2022) (“MFA Comment Letter I”); Comment Letter of American Investment Council (July 27, 2022) (“AIC Comment Letter III”).

<sup>76</sup> See, e.g., Comment Letter of Brian Cartwright, Jay Clayton, Joseph A. Grundfest, Paul G. Mahoney, Harvey L. Pitt, Adam Pritchard, James S. Spindler, Robert B. Stebbins, J.W. Verret, and Charles Whitehead (Apr. 25, 2022) (“Cartwright et al. Comment Letter”); MFA Comment Letter I (stating that the legislative history surrounding Section 211(h), and Section 913 of the Dodd-Frank Act demonstrates that Section 211(h) was clearly intended to address the relationship between retail clients and their advisers).

Frank Act,<sup>77</sup> did not intend to apply section 211(h) of the Advisers Act to private fund advisers and instead intended this section to only apply to retail investors.<sup>78</sup> Commenters also stated that the legislative history surrounding section 913(g) and section 211(h) support a narrower reading that limits these provisions to retail customers and clients.<sup>79</sup> Another commenter stated that Congress would have provided clear congressional authorization to empower the Commission to materially alter the regulatory regime for private funds if it intended to do so.<sup>80</sup>

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<sup>77</sup> Section 913(g)(2) of the Dodd-Frank Act added section 211(h) to the Advisers Act.

<sup>78</sup> *See, e.g.*, AIMA/ACC Comment Letter; MFA Comment Letter I (stating that Section 913 focused on harmonizing and standardizing the standard of conduct with respect to retail customers and clients and therefore section 913(g) should also be narrowly interpreted to apply to this subset of the investor community). Another commenter asserted that, in amending the Advisers Act to add section 211(h), it was intended to only apply to retail customers because it was part of section 913 of the Dodd-Frank Act and, further, that this interpretation is supported by section 913 of the Dodd-Frank Act permitting promulgation of a best interest standard for retail customers under the section 211(g) amendment to the Advisers Act to include certain terms that this commenter asserted would be restricted by this rulemaking but permitted under section 211(g). *See* Comment Letter of the Committee on Private Investment Funds and the Committee on Investment Management Regulation of the New York City Bar Association (Apr. 25, 2022) (“NYC Bar Comment Letter II”) (pointing to section 211(g) stating under such a best interest standard “any material conflicts of interest shall be disclosed and may be consented to by the customer” and “receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard”).

<sup>79</sup> *See, e.g.*, AIMA/ACC Comment Letter; MFA Comment Letter I. Some commenters stated that analysis of provisions in section 913 of the Dodd-Frank Act supports a reading that it was enacted in response to a concern that retail investors did not appreciate the distinction between broker-dealers and advisers. *See, e.g.*, Stuart Kaswell Comment Letter; NYC Bar Comment Letter II.

<sup>80</sup> *See* AIC Comment Letter III. We disagree. For the reasons discussed in the Proposing Release and throughout this release, our adoption of these private fund adviser rules is a proper exercise of our rulemaking authority under the Advisers Act to prevent fraudulent, deceptive, and manipulative conduct, facilitate the provision of simple and clear disclosures to investors, and prohibit or restrict certain sales practices, conflicts of interest, and compensation schemes. This commenter also asserted that before finalizing a number of rulemaking proposals affecting private fund advisers, including the proposal underlying this final rule, we must (i) “publish a reasonable assessment of the cumulative effects” of these rules, (ii) reopen the comment periods for these rules “to provide the public an opportunity to assess holistically the Commission’s proposals”, and (iii) “with the benefit of an appropriate analysis and public comment,” finalize these rules “holistically” taking into account “not just the expected effects on investors and our capital markets but also practical realities such as adoption timelines as well as information technology requirements.” Comment Letter of the American Investment Council (Aug. 8, 2023) (“AIC Comment Letter IV”). This commenter asserted that failing to do so “would be a violation of the Commission’s obligations under the Administrative Procedures Act.” The effects of any final rule may be impacted by recently adopted rules that precede it. Accordingly, each economic analysis in each adopting release considers an updated economic baseline that incorporates any new regulatory requirements, including compliance costs, at the time of each adoption, and considers the incremental new benefits and incremental new costs over those already resulting from the preceding rules. That is, the economic analysis



Section 913 of the Dodd-Frank Act contains numerous sub-parts, several of which specifically pertain to “retail customers,” which Congress defined as “a natural person, or the legal representative of such natural person, who (1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes.”<sup>81</sup> Congress also mentioned private fund investors in Section 913, specifically indicating in adding section 211(g) of the Advisers Act that “the Commission shall not ascribe a meaning to the term ‘customer’ that would include an investor in a private fund[.]”<sup>82</sup> In the same provision, in adding section 211(h) of the Advisers Act entitled “Other Matters,” Congress spoke of “investors,” and in so doing gave no indication that it was referring to “retail customers,” a term it had defined and used in various other sub-parts.<sup>83</sup> The “Other Matters” provision likewise contains no instruction to the Commission to include or exclude private fund investors from the term “investors”; in fact, it does not mention “private fund investors” at all.<sup>84</sup> This provision makes no mention of “retail” customers, “retail” clients, or “retail” investors, and therefore does not by its plain meaning apply to only *retail* investors. While commenters seek to read a “retail” limitation into the statute, that view is unsupported by the plain text of the statute.

Another commenter similarly argued that, because Congress added section 211(e) to the Advisers Act requiring the promulgation of rules to establish the form and content of certain

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appropriately considers existing regulatory requirements, including recently adopted rules, as part of its economic baseline against which the costs and benefits of the final rule are measured. *See infra* sections VI.C, VI.D.1, and VI.E.2 below.

<sup>81</sup> Dodd-Frank Act, Section 913(a).

<sup>82</sup> Dodd-Frank Act, Section 913(g)(2).

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

reports regarding private funds required to be filed with the Commission under subsection 204(b) of the Advisers Act, it “is inconceivable that Congress intended Section 211(h) to grant the broad private fund disclosure authority it claims when Congress spoke with such precision [in adding section 211(e)] within the same section of the Advisers Act.”<sup>85</sup> Contrary to this commenter’s assertion, we find again that the juxtaposition of such provisions within the amendments Congress made to 211 of the Advisers Act show Congress knew when it wanted to limit a provision to private fund advisers, when it wanted to limit a provision to retail customers, and when it wanted to apply a provision to all investment advisers and investors. Another commenter asserted that Congress only intended to regulate the activities of private funds and their investment advisers in Title IV of the Dodd-Frank Act, and not in Title IX of the Dodd-Frank Act, and thus section 211(h) cannot be read to apply to private fund advisers.<sup>86</sup> We disagree. While Title IV contains a number of provisions specific to private fund advisers, there are many other provisions of the Dodd-Frank Act applicable to private fund advisers outside of that title, and while Title IX contains provisions that affect all investment advisers, there is no indication that Congress intended to restrict its coverage to exclude private fund advisers except where it explicitly does so.<sup>87</sup>

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<sup>85</sup> See Stuart Kaswell Comment Letter II.

<sup>86</sup> See NYC Bar Comment Letter II.

<sup>87</sup> For example, there is nothing limiting the remit of the Investor Advisory Committee mandated by section 911 of the Dodd-Frank Act from considering investors in private funds and section 911 requires that such committee include representation of the interests of institutional investors, including pension funds, and thus many of the investors in private funds. There is also nothing to suggest the study of the examination of investment advisers under section 914 of the Dodd-Frank Act should exclude examination of private fund advisers. Finally, there is nothing under section 915 of the Dodd-Frank Act (codified as section 4(g) of the Exchange Act), which mandated the creation of an Investor Advocate at the Commission, to limit its remit to non-private fund advisers—indeed section 915 of the Dodd-Frank Act specifically refers to “retail investors” in some subsections and “investors” in others, showing Congress chose the application of its directives and grants of authority quite specifically. Compare section 4(g)(4)(A) of the Exchange Act (providing the Investor Advocate shall “assist retail investors in resolving significant problems such investors may have with the Commission or self-regulatory organizations”) with section 4(g)(4)(B) of the

Some commenters challenged our ability to rely on sections 211(h) and 206 of the Advisers Act on the grounds that our use of such authority directly conflicts with Congress’s intent in enacting the Investment Company Act of 1940 (“Investment Company Act”).<sup>88</sup> Specifically, commenters stated that the rules are an attempt to regulate private funds despite the fact that Congress explicitly excluded such funds from the definition of an “investment company” and therefore excluded them from regulation under the Investment Company Act. The final rules, however, regulate the activities of investment advisers to private funds, over whom the Commission has been given substantial authority, while the substantive provisions of the Investment Company Act, and rules thereunder, regulate investment companies. These final rules are not an indirect mechanism for regulating private funds because the rules focus on the adviser and do not apply to or restrict the private fund itself. For example, the rules do not dictate or limit the ability of private funds to engage in excessive leverage or borrowing,<sup>89</sup> do not regulate fund payment of redemption proceeds or require funds to comply with specific rules to maintain liquidity sufficient to meet redemptions,<sup>90</sup> do not regulate layering of fees or fund structures,<sup>91</sup> or changes in investment policies,<sup>92</sup> and do not impose a governance structure<sup>93</sup> the way that the Investment Company Act, and rules thereunder, impose such limitations on registered funds and their operations.

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Exchange Act (providing the Investor Advocate shall “identify areas in which investors would benefit from changes in the regulations of the Commission or the rules of self-regulatory organizations”).

<sup>88</sup> See, e.g., Comment Letter of the Loan Syndications and Trading Association (Apr. 25, 2022) (“LSTA Comment Letter”); Comment Letter of Citadel (May 3, 2022) (“Citadel Comment Letter”).

<sup>89</sup> See 15 U.S.C. 80a-18 and 17 CFR 270.18c-1, 17 CFR 270.18c-2, 17 CFR 270.18f-1, 17 CFR 270.18f-2, and 17 CFR 270.18f-4 under the Investment Company Act.

<sup>90</sup> See 15 U.S.C. 80a-22 and 17 CFR 270.22e-4 under the Investment Company Act.

<sup>91</sup> See 15 U.S.C. 80a-12.

<sup>92</sup> See 15 U.S.C. 80a-13.

<sup>93</sup> See 15 U.S.C. 80a-10 (independence of directors) and 15 U.S.C. 80a-16 (election of directors).

One commenter stated that Congress amended the Advisers Act to address private fund adviser registration and did not authorize a disclosure system for private funds or allow the Commission to circumvent that by putting the obligation on advisers.<sup>94</sup> We disagree. In amending the Advisers Act in connection with requiring most private fund advisers to register, Congress enacted other requirements specific to private fund advisers. For example, section 204(b) of the Act, entitled “Records and Reports of Private Funds,” specifically authorizes the Commission to require registered investment advisers to maintain such records of, and file with the Commission such reports regarding, private funds advised by the investment adviser, as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council and to provide or make available to the Council those reports or records or the information contained therein. It further provides that the records and reports of any private fund to which an investment adviser registered under this title provides investment advice shall be deemed to be the records and reports of the investment adviser. Congress thus appears to have squarely contemplated, for example, that reports regarding private funds would be achieved by putting the obligation on advisers. Even further, in amending the Advisers Act to require registration of private fund advisers, Congress did not mandate or restrict the Commission from applying rules adopted under the Advisers Act to these advisers. It did not indicate that a registered private fund adviser should be more or less subject to the Commission’s rules under the Advisers Act than any other registered adviser simply because its clients are private funds.<sup>95</sup> Where Congress intended for

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<sup>94</sup> See Stuart Kaswell Comment Letter.

<sup>95</sup> See, e.g., 17 CFR 275.204A-1 (rule 204A-1) (requiring registered advisers to adopt codes of ethics); 17 CFR 275.205-3 (permitting investment advisers to charge performance fees to certain clients); 17 CFR 275.206(4)-1 (rule 206(4)-1) (regulating registered adviser marketing); rule 206(4)-2 (regulating the custody practices of registered advisers); 17 CFR 275.206(4)-5 (rule 206(4)-5) (prohibiting registered

certain private fund advisers to be treated differently from other registered investment advisers, it has been specific.<sup>96</sup>

Some commenters stated that the rules are inconsistent with precedent treating the Advisers Act as a disclosure-based regime, that the 2019 IA Fiduciary Duty Interpretation reaffirmed the practice of consent through disclosure, and that the Commission is abandoning this approach in favor of acting as a merit regulator.<sup>97</sup> The Advisers Act sets forth specific requirements for advisers, including advisers to private funds, and confers specific rulemaking authority to the Commission in sections 206(4) and 211(h). Nowhere in these sections or in the Advisers Act more broadly did Congress provide that the Advisers Act is purely a disclosure-based regime or that the Commission's rulemaking authority with respect to the Advisers Act is limited to disclosure-based rules. Furthermore, other statutory provisions of the Advisers Act are explicit when restricting the Commission's rulemaking authority to require disclosure compared to imposing other obligations. Indeed, while section 211(h)(1) of the Act specifies that the Commission shall facilitate the provision of certain disclosures, the very next subsection (section 211(h)(2) of the Act) provides that the Commission shall examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and

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advisers and certain advisers exempt from registration from engaging in certain pay to play activities); rule 206(4)-8 (prohibiting advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles).

<sup>96</sup> For example, the various exemptions in section 203(b), the venture capital exemptions in section 203(l), and the private fund exemption in section 203(m). *See also* section 211(a) of the Act ("The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title, including rules and regulations defining technical, trade, and other terms used in this title, except that the Commission may not define the term 'client' for purposes of paragraphs (1) and (2) of section 206 to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser.")

<sup>97</sup> *See, e.g.*, Comment Letter of American Investment Council (June 13, 2022) ("AIC Comment Letter II"); SIFMA-AMG Comment Letter I.

compensation schemes. The authority granted to the Commission under section 206(4) of the Act, which enables the Commission to promulgate rules to define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative, also makes no mention of disclosure.

Similarly, the 2019 IA Fiduciary Duty Interpretation addressed advisers' fiduciary duties to their fund clients but did not state or seek to imply that advisers to private funds were otherwise exempt from the specifically worded provisions in the Advisers Act. We are not seeking to amend or change the Commission's existing rules or past interpretations of the Advisers Act with respect to private fund advisers. Rather, in this rulemaking, we are seeking to employ the rulemaking authority in sections 206(4) and 211(h) of the Act, as Congress set forth, to address the types of harms Congress specifically identified in those sections.

Other commenters argued that the Commission cannot rely on section 206 because the Commission has neither proposed to define fraudulent practices nor demonstrated how the rules would prevent fraud.<sup>98</sup> Section 206(4) gives the Commission the authority to prescribe means reasonably designed to prevent fraud, and we are employing the authority that Congress provided us in section 206(4). As detailed below in the discussion of the final rules in section II of the release, the rules we are adopting today are reasonably designed to prevent fraud, deception, or manipulation because, for example, requiring advisers to provide enhanced disclosure around potential and actual conflicts of interest decreases the likelihood that investors will be defrauded by certain practices, many of which involve conflicts of interest.<sup>99</sup> In addition, preventing

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<sup>98</sup> See, e.g., Citadel Comment Letter (discussing indemnification clauses); NYC Bar Comment Letter II.

<sup>99</sup> The audit rule increases the likelihood that fraudulent activity or problems with valuation are uncovered, thereby deterring advisers from engaging in fraudulent conduct. Similarly, the quarterly statement rule increases the likelihood that fraudulent activity or problems with fees, expenses, and performance are uncovered, thereby deterring advisers from engaging in fraudulent conduct. The adviser-led secondaries

advisers from engaging in certain activities, in some cases unless they provide disclosure, is another means to prevent fraud, deception, or manipulation.

Some commenters stated that the “sales practices,” “conflicts of interest” and “compensation schemes” referenced in section 211(h) should be read and understood all together in the context of an advisory relationship, not as a list of distinct items, but as sales practices that lead to conflicts of interest with associated compensation schemes, and that the word “certain” also underscores the limited reach of these terms’ combined meaning.<sup>100</sup> These commenters’ reading would effectively eliminate “conflicts of interest” and “compensation schemes” from the statutory language and reduce section 211(h)(2) to refer only to certain sales practices. We see no basis for reading out of the statute words Congress specifically chose to include. First, by providing a specific list of items in section 211(h) that the Commission “shall examine and, where appropriate, promulgate rules,” Congress intended for the Commission to address this particularized set of scenarios—“sales practices, conflicts of interest, and compensation schemes”—via rulemaking. Accordingly, we have sought to identify clearly which of these scenarios we are attempting to address in each rule that is based on our rulemaking authority under section 211(h). Second, we agree that “certain” indicates that 211(h) does not apply to all sales practices, conflicts of interest and compensation schemes, but rather only those that, after examination, the Commission deems contrary to the public interest and protection of investors. Following our examination, as described in this release, these rules aim to restrict only sales

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rule is designed to ensure that the private fund and investors that participate in the secondary transaction are offered a fair price, which is a critical component of preventing the type of harm that might result from the adviser’s conflict of interest in leading the transaction. The restricted activities rule and preferential treatment rule prevent advisers from engaging in certain activities that could result in fraud and investor harm, unless advisers make appropriate disclosures or obtain consent, as applicable.

<sup>100</sup> See, e.g., Comment Letter of American Investment Council (Apr. 25, 2022) (“AIC Comment Letter I”); Citadel Comment Letter.

practices, conflicts of interest and compensation schemes that we believe are harmful to investors. There are other examples of sales practices, conflicts of interest and compensation schemes in the private fund industry that are not addressed in this rulemaking, some of which we do not currently view as rising to the level of concern set forth in section 211(h).

Some commenters offered their own interpretations of the term “sales practices.”<sup>101</sup> A commenter interpreted the plain meaning of “sales practice” to be “a mode or method of making sales,”<sup>102</sup> while another commenter interpreted “sales practice” to be “a repeated or customary manner of promoting or selling goods.”<sup>103</sup> Some commenters suggested cold calling as an example of a “sales practice.”<sup>104</sup> Yet another commenter interpreted “sales practice” to apply only to “an adviser’s marketing or promotion of its funds.”<sup>105</sup> We agree that such interpretations involve a sales practice, and we have taken them into consideration in interpreting this term. Our interpretation is appropriate because it is sufficiently broad to capture sales practices as they continue to evolve in the industry but not so broad as to capture operational activities that are independent of sales functions. Likewise, our interpretation of “sales practice” is not so narrow that it would exclude conduct that should be within scope. For example, the term would not exclude conduct because it is not “repeated” or “customary.” Similarly, it would not exclude activity that follows a period of marketing or promotion when an adviser takes steps to effectuate an investment.

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<sup>101</sup> See, e.g., Comment Letter of Haynes and Boone, LLP (Apr. 25, 2022) (“Haynes & Boone Comment Letter”); Comment Letter of Committee on Capital Market Regulation (Oct. 17, 2022) (“CCMR Comment Letter II”); Citadel Comment Letter.

<sup>102</sup> See AIC Comment Letter I.

<sup>103</sup> See CCMR Comment Letter II.

<sup>104</sup> See, e.g., AIC Comment Letter I; Citadel Comment Letter.

<sup>105</sup> See Haynes & Boone Comment Letter.



Likewise, the staff has broadly interpreted the term “compensation,” explaining that “the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the total services rendered, commissions, or some other combination of the foregoing” would satisfy the “for compensation” prong of the definition of investment adviser set forth in Section 202(a)(11) of the Advisers Act.<sup>106</sup> A commenter suggested that fees and expenses being passed on to investors, such as accelerated monitoring fees, costs related to governmental or regulatory investigations, compliance expenses, and costs related to obtaining external financing, should be characterized as “compensation schemes.”<sup>107</sup> Another commenter suggested that we distinguish between “compensation” and “reimbursement” for purposes of defining a “compensation scheme.”<sup>108</sup> Previously, our staff has explained that the receipt of any economic benefit to a person providing a variety of services to a client, including investment advisory services, qualifies as “compensation.”<sup>109</sup> It has consistently recognized that reimbursements covering only the cost of services are “compensation.”<sup>110</sup> And staff has viewed “compensation” as including indirect payments for investment advisory services.<sup>111</sup> We similarly broadly interpret the term “compensation scheme” for purposes of this rulemaking to include any manner

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<sup>106</sup> Applicability of the Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) (“Release 1092”). *See also United States v. Miller*, 833 F.3d 274 (3d Cir. 2016).

<sup>107</sup> *See* United for Respect Comment Letter I.

<sup>108</sup> *See* Haynes & Boone Comment Letter.

<sup>109</sup> *See* Release 1092, *supra* footnote 106, at 10.

<sup>110</sup> CFS Securities Corp., SEC Staff Letter (Feb. 27, 1987) (expressing the staff’s view that a fee designed to cover costs would constitute ‘special compensation’); Touche Holdings, Inc., SEC Staff Letter (Nov. 30, 1987) (explaining the staff’s view that “[t]he compensation element is satisfied even if payments for services only cover the cost of the services”).

<sup>111</sup> *See* Release 1092, *supra* footnote 106, at 10.

in which an investment adviser is compensated and receives economic benefit — directly or indirectly — for providing services to its clients.<sup>112</sup>

Commenters also argued that the Commission’s approach runs contrary to the D.C. Circuit Court’s decision in *Goldstein v. SEC*.<sup>113</sup> One commenter stated that the proposal, by offering protections directly to private fund investors, relies on the same “look-through” approach that the D.C. Circuit rejected in *Goldstein v. SEC*.<sup>114</sup> The exercise of our statutory authority under sections 211(h) and 206(4) is not inconsistent with the court’s ruling in *Goldstein v. SEC* because section 206(4) is not limited in its application to “clients” and section 211(h) was designed to provide protection to “investors.” Notably, neither section 206(4) nor 211(h) references “client,” and section 211(h) references “investors” which does not exclude any particular type of investor, such as private fund investors. A plain interpretation of the statute supports a reading that Congress intended to allow the Commission to promulgate rules to protect investors directly (including private fund investors) and therefore does not contradict the court’s ruling in *Goldstein v. SEC*.<sup>115</sup> Moreover, private fund advisers are already subject to rule

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<sup>112</sup> One commenter supported a broad interpretation of “compensation scheme” and suggested that this authority has the potential to address significant failures in our markets. *See* Consumer Federation of American Comment Letter. However, another commenter maintained that the statutory context indicates that “compensation schemes” should be interpreted to refer to structural incentives that may encourage a broker-dealer or investment adviser to push an investor into an unsuitable transaction. *See* AIC Comment Letter I. As discussed above, this suggested interpretation would effectively eliminate “conflicts of interest” and “compensation schemes” from the statutory language and reduce section 211(h)(2) to refer only to certain sales practices. We see no basis for reading out of the statute words Congress specifically chose to include. Another commenter stated that “compensation scheme” has yet to be applied or interpreted to prohibit indemnification provisions or the passing through of certain fee and expense types. *See* Comment Letter of Committee on Capital Market Regulation (Apr. 25, 2022) (“CCMR Comment Letter I”).

<sup>113</sup> *See, e.g.*, MFA Comment Letter I; AIC Comment Letter I; *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (“*Goldstein v. SEC*”).

<sup>114</sup> *See* AIC Comment Letter I; *Goldstein v. SEC*, *supra* footnote 113 (clarifying that the “client” of an investment adviser managing a pool is the pool itself, not an investor in the pool).

<sup>115</sup> Further, the Dodd-Frank Act eliminated the “private adviser” exemption under section 203(b)(3) of the Advisers Act, which the court interpreted in *Goldstein v. SEC*. Thus, we do not believe the court’s ruling in *Goldstein v. SEC* is necessarily relevant because we are not relying on repealed section 203(b)(3).

206(4)-8 under the Advisers Act, which prohibits investment advisers to pooled investment vehicles, which include private funds, from engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.<sup>116</sup> We recognize that the private fund is the adviser’s client, but this rulemaking addresses with particularity the risk of fraud, deception, or manipulation upon investors in private funds. As a means of preventing fraudulent, deceptive, or manipulative acts upon the fund, we are also addressing the relationship with the fund investors, with whom the adviser typically negotiates the terms of its relationship with the fund. Moreover, as fund clients often lack an effective governance process that is independent of the adviser to receive or provide consent,<sup>117</sup> these rules protect both the fund and its investors by empowering investors to receive disclosure and provide such informed consent.

Relatedly, some commenters stated that our interpretation of our authority under section 211(h) is inconsistent with the fact that, at the same time it added section 211(h), Congress amended 211(a) to clarify that advisers do not owe a duty to private fund investors.<sup>118</sup> On the contrary, the fact that Congress made these amendments to 211(a) at the same time it added section 211(h) supports our interpretation. In amending section 211(a), Congress made an explicit differentiation between a fund client of an adviser and investors in such fund client for purposes of establishing potential liability under sections 206(1) and 206(2) of the Advisers Act in the Advisers Act. However, Congress did not frame 211(h) in such terms. Rather, Congress did not use the term “client” in 211(h) at all but used the term “investors” specifically in 211(h).

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<sup>116</sup> See rule 206(4)-8 under the Advisers Act.

<sup>117</sup> See *supra* section I.A.

<sup>118</sup> See, e.g., Stuart Kaswell Comment Letter; AIC Comment Letter II.

Congress addressed adviser-client relationships when it wished, but used a different framing and different terms in 211(h).

Some commenters stated that section 205 provides the only authority under the Advisers Act to regulate contracts and that section 205(b) carves out contracts with funds exempt from the Investment Company Act under section 3(c)(7) of that Act.<sup>119</sup> While section 205(a) provides authority under the Advisers Act to regulate investment advisory contracts, it does not state that such contracts or private funds are otherwise not subject to the other provisions of the Advisers Act, including disclosure requirements, antifraud provisions, or other investor protection provisions. The plain interpretation of section 205 is that Congress intended to exempt certain private funds from the prohibition on the specified advisory contract terms set forth in section 205(a) but did not otherwise attempt to imply that private funds are broadly exempted from the requirements of the Advisers Act.

## **II. DISCUSSION OF RULES FOR PRIVATE FUND ADVISERS**

### **A. Scope of Advisers Subject to the Final Private Fund Adviser Rules**

The scope of advisers subject to the final private fund adviser rules is unchanged from the proposal, except as discussed below with respect to advisers to securitized asset fund.<sup>120</sup> The quarterly statement, audit, and adviser-led secondaries rule apply to all SEC-registered advisers, and the restricted activities and preferential treatment rules apply to all advisers to private funds, regardless of whether they are registered with the Commission. Our scoping decisions generally align with the Commission's historical approach and are based on the fact that the quarterly

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<sup>119</sup> See, e.g., SIFMA-AMG Comment Letter I; Comment Letter of Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (Apr. 28, 2022); MFA Comment Letter I.

<sup>120</sup> The final quarterly statement, audit, adviser-led secondaries, restricted activities, and preferential treatment rules do not apply to investment advisers with respect to securitized asset funds they advise. See discussion below in this section II.A. All references to private funds shall not include securitized asset funds.

statement, audit, and adviser-led secondaries rules impose affirmative obligations on advisers, while the restricted activities and preferential treatment rules prohibit activity or require disclosure and, in some cases, consent.<sup>121</sup>

Commenters generally supported the proposed application of the quarterly statement rule, audit rule, and adviser-led secondaries rule to SEC-registered advisers.<sup>122</sup> One commenter asserted that the proposed quarterly statement rule and audit rule should also apply to exempt reporting advisers (“ERAs”),<sup>123</sup> arguing that investors in private funds advised by ERAs would similarly benefit from information about the funds’ fees, expenses, and performance and from fund audits.<sup>124</sup> Other commenters asked for clarification that the proposed quarterly statement rule, audit rule, and adviser-led secondaries rule would not apply to an adviser whose principal office and place of business is outside of the United States (offshore adviser) with regard to any of its non-U.S. private fund clients even if the non-U.S. private fund clients have U.S. investors.<sup>125</sup>

We are applying these three rules to SEC-registered advisers, as proposed. No commenter requested we extend application of the adviser-led secondaries rule to ERAs or other

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<sup>121</sup> Compare the affirmative obligations in rule 204A-1 (requiring SEC-registered investment advisers to, among other things, establish, maintain and enforce a written code of ethics) and rule 206(4)-2 (requiring SEC-registered investment advisers to follow certain practices if they have custody of client funds or securities) with the prohibition in rule 206(4)-8 (prohibiting both registered and unregistered investment advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles).

<sup>122</sup> See, e.g., AIMA/ACC Comment Letter (adviser-led secondaries rule); Comment Letter of Standards Board for Alternative Investments (Apr. 25, 2022) (“SBAI Comment Letter”) (adviser-led secondaries rule, quarterly statement rule); Comment Letter of Andrew (Apr. 25, 2022) (quarterly statement rule).

<sup>123</sup> An exempt reporting adviser is an investment adviser that qualifies for the exemption from registration under section 203(l) of the Advisers Act or 17 CFR 275.203(m)-1 (rule 203(m)-1) under the Advisers Act.

<sup>124</sup> Comment Letter of the North American Securities Administrators Association, Inc. (Apr. 25, 2022) (“NASAA Comment Letter”).

<sup>125</sup> See, e.g., AIC Comment Letter II; Comment Letter of the British Private Equity and Venture Capital Association (Apr. 25, 2022) (“BVCA Comment Letter”); PIFF Comment Letter.

unregistered advisers. Regarding the quarterly statement rule, we believe extending the rule to ERAs, such as venture capital fund advisers, would raise matters that we believe would benefit from further consideration—for example, whether different fee, expense, and performance information might be informative in the context of start-up investments. Similarly, while one commenter asserted that many ERAs are already obtaining audits and thus application of the audit rule would benefit investors in ERA-advised funds, we received no other comments on this topic and believe we would benefit from further comment on the benefits and costs of such a requirement, particularly from smaller ERAs.

We have previously stated, and continue to take the position, that we do not apply most of the substantive provisions of the Advisers Act with respect to the non-U.S. clients (including private funds) of an SEC-registered offshore adviser.<sup>126</sup> This approach was designed to provide appropriate flexibility where an adviser has its principal office and place of business outside of the United States.<sup>127</sup> It is appropriate to continue to apply this historical approach to these three new rules. The quarterly statement rule, audit rule, and adviser-led secondaries rule are

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<sup>126</sup> See, e.g., Exemptions Adopting Release, *supra* footnote 9, at 77 (Most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients of a non-U.S. adviser registered with the Commission.); Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054, 72072 (Dec. 10, 2004)] (“Hedge Fund Adviser Release”) (stating that the following rules under the Advisers Act would not apply to a registered offshore adviser, assuming it has no U.S. clients: compliance rule, custody rule, and proxy voting rule and stating that the Commission would not subject an offshore adviser to the rules governing adviser advertising [17 CFR 275.206(4)-1], or cash solicitations [17 CFR 275.206(4)-3] with respect to offshore clients). We note that our staff has taken a similar position. See, e.g., American Bar Association, SEC Staff No-Action Letter (Aug. 10, 2006) (confirming that the substantive provisions of the Act do not apply to offshore advisers with respect to those advisers’ offshore clients (including offshore funds) to the extent described in those letters and the Hedge Fund Adviser Release); Information Update For Advisers Relying On The Unibanco No-Action Letters, IM Information Update No. 2017-03 (Mar. 2017). Any staff statements cited represent the views of the staff. They are not a rule, regulation, or statement of the Commission. Furthermore, the Commission has neither approved nor disapproved their content. These staff statements, like all staff statements, have no legal force or effect: they do not alter or amend applicable law; and they create no new or additional obligations for any person.

<sup>127</sup> See, e.g., Investment Adviser Marketing, Investment Advisers Act Release No. 5653 (Dec. 22, 2021), at n.200 (“Marketing Release”).

substantive rules under the Advisers Act that we will not apply with respect to the non-U.S. private fund clients of an SEC-registered offshore adviser (regardless of whether they have U.S. investors).

The restricted activities rule prohibits all private fund advisers, regardless of registration status, from engaging in certain sales practices, conflicts of interest, and compensation schemes, unless the adviser satisfies certain disclosure, and, in some cases, consent obligations. Likewise, the preferential treatment rule prohibits all private fund advisers, regardless of registration status, from providing preferential treatment to any investor in a private fund (and in some cases to any investor in a similar pool of assets), unless the adviser satisfies certain disclosure obligations.

We proposed to continue to apply the Commission’s historical position on the substantive provisions of the Advisers Act to the prohibited activities rule such that the rule would not apply with respect to a registered offshore adviser’s non-U.S. private funds, regardless of whether those funds have U.S. investors.<sup>128</sup> We requested comment on whether this approach should apply to the proposed prohibited activities rule and the other proposed rules.<sup>129</sup> Several commenters supported applying the Commission’s historical approach to all of the proposed rules.<sup>130</sup> Other commenters stated that the Commission’s historical approach should not apply to the proposed prohibited activities rule because it is the domicile of the investor and not the domicile of the private fund that is most important for protecting U.S. investors.<sup>131</sup> The

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<sup>128</sup> See Proposing Release, *supra* footnote 3, at section II.D.

<sup>129</sup> See Proposing Release, *supra* footnote 3, at section II.D.

<sup>130</sup> See, e.g., BVCA Comment Letter; Comment Letter of Invest Europe (Apr. 25, 2022) (“Invest Europe Comment Letter”); AIC Comment Letter II; PIFF Comment Letter; AIMA/ACC Comment Letter.

<sup>131</sup> See, e.g., Healthy Markets Comment Letter I; Consumer Federation of America Comment Letter.

Commission's historical approach applies such that none of the final rules or amendments apply with respect to the offshore fund clients of an SEC-registered offshore adviser.

One commenter stated that the proposed prohibited activities rule and the preferential treatment rule should not apply to an *unregistered* offshore adviser to offshore private funds because the proposal would result in SEC-registered offshore advisers being subject to *less* regulation than offshore ERAs and other offshore unregistered advisers.<sup>132</sup> This commenter stated that the result would be that offshore SEC-registered advisers to offshore funds would benefit by avoiding the proposed prohibited activities rule and preferential treatment rule, while unregistered offshore advisers to offshore funds would be subject to these two rules.<sup>133</sup> Other commenters requested clarification that the two rules would not apply to offshore advisers, regardless of their registration status.<sup>134</sup> We agree with commenters and clarify that the restricted activities rule and the preferential treatment rule do not apply to offshore unregistered advisers with respect to their offshore funds (regardless of whether the funds have U.S. investors). This scoping is consistent with our historical treatment of other types of offshore advisers, including ERAs,<sup>135</sup> advisers relying on the foreign private adviser exemption,<sup>136</sup> and other unregistered advisers. One commenter stated that the Commission has historically limited

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<sup>132</sup> AIMA/ACC Comment Letter. *See also* SIFMA-AMG Comment Letter I.

<sup>133</sup> AIMA/ACC Comment Letter.

<sup>134</sup> *See, e.g.*, BVCA Comment Letter; Invest Europe Comment Letter.

<sup>135</sup> *See* Exemptions Adopting Release, *supra* footnote 9, at 77 (stating that disregarding an offshore adviser's activities for purposes of the private fund adviser exemption reflects our long-held view that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and that this territorial approach is in keeping with general principles of international comity); *see also id.* at 96 (stating that non-U.S. advisers relying on the private fund adviser exemption are subject to the Advisers Act antifraud provisions).

<sup>136</sup> Section 402 of the Dodd-Frank Act; section 202(a)(30) of the Advisers Act.



the application of prescriptive rules to offshore advisers.<sup>137</sup> This approach is also consistent with our historical position of not applying substantive provisions of the Advisers Act to SEC-registered offshore advisers with respect to their offshore clients, including private fund clients.<sup>138</sup>

It is appropriate to apply these two rules to all investment advisers, regardless of registration status, because these rules focus on prohibiting advisers from engaging in certain problematic sales practices, conflicts of interest, or compensation schemes.<sup>139</sup> Also, these rules are adopted pursuant to the authority under section 206 of the Advisers Act, which applies to all investment advisers, regardless of registration status.<sup>140</sup>

Several commenters addressed the proposed scope of the prohibited activities rule and the preferential treatment rule, and many commenters supported a narrower scope.<sup>141</sup> For example, one commenter stated that the application of the proposed prohibited activities rule to State-registered advisers would upend the balance of State and Federal authority that the National Securities Markets Improvement Act (“NSMIA”) established.<sup>142</sup> We do not believe that the

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<sup>137</sup> BVCA Comment Letter.

<sup>138</sup> BVCA Comment Letter; *see* Hedge Fund Adviser Release, *supra* footnote 126, at section II.D.4.c.

<sup>139</sup> *See* section 211(h)(2) of the Advisers Act. Section 211(h)(2) of the Advisers Act applies to SEC- and State-registered advisers as well as other advisers that are exempt from registration and advisers that are prohibited from registering under the Advisers Act.

<sup>140</sup> *See* 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at n.3 (stating that section 206 of the Advisers Act applies to SEC- and State-registered advisers as well as other advisers that are exempt from registration and advisers that are prohibited from registering under the Advisers Act).

<sup>141</sup> *See, e.g.*, Comment Letter of the Investment Adviser Association (Apr. 25, 2022) (“IAA Comment Letter II”) (arguing that the prohibited activities rule should not apply to State-registered advisers or ERAs, regardless of whether they are onshore or offshore); Comment Letter of Schulte Roth & Zabel LLP (Apr. 25, 2022) (“Schulte Comment Letter”) (arguing that the prohibited activities rule and preferential treatment rule should not apply to unregistered advisers); AIMA/ACC Comment Letter (arguing that all of the rules should not apply to ERAs and advisers relying on the foreign private adviser exemption); SBAI Comment Letter (arguing that the prohibited activities rule should only apply to SEC RIAs).

<sup>142</sup> IAA Comment Letter II.

application of the restricted activities rule and the preferential treatment rule to State-registered advisers and advisers that are otherwise subject to State regulation (*e.g.*, advisers that are exempt from State registration) runs contrary to the lines NSMIA established because we are adopting these two rules under sections 206 and 211 of the Advisers Act, which sections apply to all advisers.<sup>143</sup> Commission rules adopted using this authority, accordingly, may apply to all advisers, regardless of their registration status.<sup>144</sup> In contrast, other commenters either supported the scope of the rules as proposed or supported an even broader scope.<sup>145</sup>

We are not narrowing the scope of the restricted activities and preferential treatment rules to exclude ERAs, State-regulated advisers, advisers relying on the foreign private adviser exemption, or advisers that are otherwise unregistered. The sales practices, conflicts of interest, and compensation schemes addressed by the restricted activities rule and the preferential treatment rule can lead to advisers placing their interests ahead of their clients' (and, by extension, their investors') interests, and can result in significant harm to the private fund and its investors. As a result, all of these advisers are subject to the restricted activities rule and the preferential treatment rule. A number of our enforcement cases against advisers to private funds based on conflicts of interests have been brought against advisers that are not registered under

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<sup>143</sup> Moreover, this approach is consistent with the historical scope of section 206 of the Advisers Act, which was enacted before, and was unchanged by, the enactment of NSMIA.

<sup>144</sup> Rule 206(4)-8 under the Advisers Act, for example, was adopted under section 206(4) and applies to all unregistered advisers, including State-registered advisers. *See* Prohibition of Fraud Adopting Release, *supra* footnote 67), at 7, n.16 (“[o]ur adoption of [rule 206(4)-8] will not alter our jurisdictional authority”). *See also* Comment Letter of NASAA on Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles (Dec. 27, 2006) (“NASAA supports the application of the proposed rule to advisers registered or required to register at the state level.”).

<sup>145</sup> *See, e.g.*, NASAA Comment Letter (stating that “the Proposal appropriately prohibits these activities for all PFAs [private fund advisers], not only those registered or required to be registered with the SEC”); Healthy Markets Comment Letter I; Consumer Federation of America Comment Letter (both stating that the prohibited activities rule should also apply with respect to an offshore private fund managed by an offshore SEC-registered investment adviser where such fund has U.S. investors).

the Advisers Act,<sup>146</sup> and we believe this demonstrates a need to apply these rules to unregistered private fund advisers.<sup>147</sup>

### *Investment Advisers to Securitized Asset Funds*

The final quarterly statement, restricted activities, adviser-led secondaries, preferential treatment, and audit rules do not apply to investment advisers with respect to securitized asset funds (we refer to these advisers, solely with respect to the securitized asset funds they advise, as “SAF advisers”). These advisers will not be required to comply with the requirements of the final rules solely with respect to the securitized asset funds (“SAFs”) that they advise.<sup>148</sup>

Some commenters requested for all or some of the proposed rules not to apply to advisers to securitization vehicles or vehicles that issue asset-backed securities (in particular, collateralized loan obligations (“CLOs”)).<sup>149</sup> One commenter stated that the Commission did not

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<sup>146</sup> See, e.g., *In the Matter of SparkLabs Global Ventures Management, LLC*, Investment Advisers Act Release No. 6121 (Sept. 12, 2022) (settled action) (alleging unregistered advisers that managed private funds breached their fiduciary duty by causing private fund clients to lend to each other in violation of the funds’ governing documents and failing to disclose conflicts of interest to the funds); *In the Matter of Augustine Capital Management, LLC*, Investment Advisers Act Release No. 4800 (Oct. 26, 2017) (settled action) (alleging unregistered private fund adviser caused the fund client to engage in conflicted transactions, including investments and loans, without disclosure to or consent by investors); *In the Matter of Alumni Ventures Group, LLC*, Investment Advisers Act Release No. 5975 (Mar. 4, 2022) (settled action) (alleging exempt reporting adviser that managed private funds breached its fiduciary duty by causing private fund clients to lend to each other in violation of the funds’ governing documents and failing to disclose conflicts of interest to the fund investors).

<sup>147</sup> This approach is consistent with another rule adopted under section 206 of the Advisers Act, rule 206(4)-5, which applies to SEC-registered advisers, advisers relying on the foreign private adviser exemption, and ERAs. Rule 206(4)-5 was intended to combat pay-to-play arrangements in which advisers are chosen based on their campaign contributions to political officials rather than on merit. Rule 206(4)-5 applies to an investment adviser registered (or required to be registered) with the Commission or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act, or that is an exempt reporting adviser, as defined in rule 17 CFR 275.204-4(a) under the Advisers Act.

<sup>148</sup> If an investment adviser that is a SAF adviser also advises other private funds that are not securitized asset funds, the investment adviser will be subject to the final rules with respect to such other private funds.

<sup>149</sup> See Comment Letter of Ropes & Gray LLP (Apr. 25, 2022) (“Ropes & Gray Comment Letter”); LSTA Comment Letter; SIFMA-AMG Comment Letter I; Comment Letter of Teachers Insurance and Annuity Association of America (Apr. 25, 2022) (“TIAA Comment Letter”); Comment Letter of Fixed Income Investor Network (Apr. 29, 2022) (“Fixed Income Investor Network Comment Letter”); PIFF Comment Letter; Comment Letter of Structured Finance Association (Apr. 25, 2022) (“SFA Comment Letter I”).

identify specific concerns with SAFs, the rules were generally not applicable to SAFs, and that the rules did not address or contemplate the critical differences between these types of vehicles and other private funds.<sup>150</sup> Another commenter stated that, although SAFs are private funds, their structure and purpose are sufficiently distinct from other types of funds that their advisers should be exempt from the rules.<sup>151</sup> This commenter stated that SAFs are unlike private funds in several ways, including because: (i) SAFs do not issue equity but rather issue notes at various seniorities that entitle holders to interest payments and ultimate repayment of principal; (ii) SAFs do not have general partners affiliated with their advisers but rather have unaffiliated trustees as fiduciary agents of the SAF investors; and (iii) their notes are held in street name and traded such that an adviser does not necessarily know who the noteholders are.<sup>152</sup>

After considering comments, we are not applying the five private fund adviser rules to SAF advisers.<sup>153</sup> This approach avoids subjecting SAF advisers to obligations that were designed to address conduct we have observed in other parts of the private fund advisers industry, including with respect to advisers to hedge funds, private equity funds, venture capital funds, real estate funds, credit funds, hybrid funds, and other non-securitized asset funds (“non-

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Although commenters generally focused on the application of the proposed rules to CLOs, certain commenters clarified that their comments applied also more broadly to securitization vehicles and vehicles that issue asset-backed securities. *See* LSTA Comment Letter; SFA Comment Letter I; SIFMA-AMG Comment Letter I; PIFF Comment Letter.

<sup>150</sup> *See* LSTA Comment Letter.

<sup>151</sup> *See* Ropes & Gray Comment Letter.

<sup>152</sup> *See id.*

<sup>153</sup> Except as specified, we are not altering the applicability of the Advisers Act, or any rules adopted thereunder, to SAF advisers. For example, Section 206 and rule 206(4)-8 will continue to apply to SAF advisers with respect to SAFs (and any other private funds) they advise. We are also not limiting the scope of advisers subject to the Advisers Act compliance rule and thus all SEC-registered advisers, including SEC-registered SAF advisers, must document the annual review of their compliance policies and procedures in writing.

SAF advisers”). We believe that the certain distinguishing structural and operational features of SAFs have together deterred SAF advisers from engaging in the type of conduct that the final rules seek to address. We also believe that the advisory relationship for SAF advisers and their clients presents different regulatory issues than the advisory relationship for non-SAF advisers and their clients. The final rules generally are not designed to take into account these differences, which together sufficiently distinguish SAFs from other types of private funds to warrant this approach.<sup>154</sup> As a result, we do not believe that the private fund adviser rules we are adopting here are the appropriate tool to regulate SAF advisers.

#### *Definition of Securitized Asset Fund*

The final rule will define SAF as “any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders.”<sup>155</sup> This definition, which is based on the corresponding definition for “securitized asset fund” in Form PF and Form ADV, is designed to capture vehicles established for the purpose of issuing asset backed securities, such as collateralized loan obligations. SAFs are special purpose vehicles or other entities that “securitize” assets by pooling and converting them into securities that are offered and sold in the capital markets. The definition therefore will not capture traditional hedge funds, private equity funds, venture capital funds, real estate funds, and credit funds.<sup>156</sup> These private

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<sup>154</sup> We will, however, continue to consider whether any additional regulatory action may be necessary with respect to SAF advisers in the future.

<sup>155</sup> See final rule 211(h)(1)-1.

<sup>156</sup> We recognize that certain private funds have, in recent years, made modifications to their terms and structure to facilitate insurance company investors’ compliance with regulatory capital requirements to which they may be subject. These funds, which are typically structured as rated note funds, often issue both equity and debt interests to the insurance company investors, rather than only equity interests. Whether such rated note funds meet the SAF definition depends on the facts and circumstances. However, based on staff experience, the modifications to the fund’s terms generally leave “debt” interests substantially equivalent in substance to equity interests, and advisers typically treat the debt investors substantially the same as the equity investors (*e.g.*, holders of the “debt” interests have the same or

funds should not meet the definition because they typically have primarily equity investors, rather than debt investors, and/or they do not have a primary purpose of issuing asset backed securities. It is appropriate to apply the final rules to advisers with respect to these private funds because they present the concerns the final rules seek to address (*i.e.*, lack of transparency, conflicts of interest, and lack of governance).

In the context of requesting that the rule not apply with respect to collateralized loan obligations, one commenter stated that the final rule should use the following definition: any special purpose vehicle advised by an investment adviser that (A) (i) issues tradeable asset-backed securities or loans, the debt tranches of which are rated; and (ii) has at least 80% of its assets comprised of leveraged loans and cash equivalents; (B) is required by its governing transaction documents to appoint an unaffiliated person to, among other things, (i) calculate certain overcollateralization and interest coverage tests; (ii) prepare and make available to investors reports on the CLO, and (iii) make the indenture readily available to investors; and (C) appoints an independent accounting firm to perform a series of agreed upon procedures. Another commenter, when requesting exemptions or other relief from the rules, generally referred to these vehicles as “special purpose vehicles that issue asset backed securities,” while another commenter used the term “collateralized loan obligations and similar credit securitization products.”

The definition in the final rule will include the types of funds described by these commenters. The definition of SAFs in the final rule, however, is one that many advisers are

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substantially the same rights as the holders of the equity interests). We would not view investors that have equity-investor rights (e.g., no right to repayment following an event of default) as holding “debt” under the definition, even if fund documents refer to such persons as “debt investors” or they otherwise hold “notes.” Further, we do not believe that many rated note funds will meet the other prong of the definition (*i.e.*, a private fund whose primary purpose is to issue asset backed securities), because they generally do not issue asset-backed securities.

familiar with because it is used in both Form PF and Form ADV. For example, Item 7.B. and Schedule D of Form ADV ask whether the private fund is a securitized asset fund or another type of private fund, such as a hedge fund or private equity fund.<sup>157</sup> Also, under Form PF, certain advisers to securitized asset funds are required to complete Section 1, which requires an adviser to report certain identifying information about itself and the private funds it advises.<sup>158</sup> We also chose this definition because it captures the core characteristics that differentiate these vehicles from other types of private funds: vehicles that issue asset-backed securities collateralized by an underlying pool of assets and that have primarily debt investors. Thus, as discussed above, traditional private funds, would not meet this definition.<sup>159</sup>

#### *Distinguishing SAF Characteristics and Features*

Although SAFs generally rely on the same exclusions from treatment as an “investment company” under the Investment Company Act as other types of private funds (*i.e.*, sections 3(c)(1) and (7) thereunder), we agree with commenters that certain fundamental structural and operational differences together sufficiently distinguish them from other types of private funds to warrant carving them out of the final rules. These fundamental differences, when considered in combination with the existing governance and transparency requirements of SAFs, would cause much of the rules to be generally inapplicable and/or ineffective with respect to achieving the rulemaking’s goals. Below we provide examples of these distinguishing features and how they relate to certain aspects of the final rules.

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<sup>157</sup> See Form ADV, Section 7.B.(1) and Schedule D Private Fund Reporting, Question 10.

<sup>158</sup> See Form PF, Section 1a, Question 3.

<sup>159</sup> We would also not view, depending on the facts and circumstances, private credit funds that borrow from third party lenders to enhance performance with fund-level leverage and invest in underlying loans alongside the equity investors as meeting this definition, even if they borrow an amount greater than the value of the equity interests they issue.

We agree with commenters that SAFs have structural features that distinguish them from most other private funds that are relevant in assessing the benefit of an audit to investors. Commenters stated that Generally Accepted Accounting Principles (“GAAP”) financial statements are not typically considered relevant for SAFs.<sup>160</sup> One commenter stated that GAAP’s efforts to assign, through accruals, a period to a given expense or income are not useful, and potentially confusing, for SAF investors because principal, interest, and expenses of administration of assets can only be paid from cash received.<sup>161</sup> We recognize that vehicles that issue asset-backed securities are specifically excluded from other Commission rules that require issuers to provide audited GAAP financial statements.<sup>162</sup> Previously, we have stated that GAAP financial information generally does not provide useful information to investors in asset-backed securities.<sup>163</sup> Instead, SAF and other asset-backed securities investors have historically been interested in information regarding characteristics and quality of the underlying assets used to pay the notes issued by the issuer, the standards for the servicing of the underlying assets, the timing and receipt of cash flows from those assets, and the structure for distribution of those cash flows.<sup>164</sup> We continue to believe that GAAP financial statements may be less useful to SAF investors than they are for non-SAF investors.

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<sup>160</sup> See LSTA Comment Letter; SFA Comment Letter I; Fixed Income Investor Network Comment Letter; TIAA Comment Letter. This view by commenters is consistent with the low rate of audits of U.S. GAAP financial statements for SAFs. However, approximately 10% of SAFs do get audits of U.S. GAAP financial statements from independent auditors that are Public Company Accounting Oversight Board (“PCAOB”)-registered and -inspected. See *infra* section VI.C.1. Advisers to these funds would not be prohibited under the final rules from continuing to cause the fund to undergo such an audit of U.S. GAAP financial statements.

<sup>161</sup> See LSTA Comment Letter.

<sup>162</sup> See Asset-Backed Securities, Securities Act Release No. 8518 (Dec. 22, 2004) (adopting disclosure requirements for asset-backed securities issuers) (<https://www.sec.gov/rules/final/33-8518.htm>).

<sup>163</sup> See *id.*

<sup>164</sup> See *id.*



SAFs also have features that distinguish them from most other private funds that are relevant in assessing the benefit of the preferential treatment rule. Based on staff experience, SAFs typically issue primarily tradeable, interest-bearing debt securities backed by income-producing assets, unlike other private funds that typically issue equity securities to investors. These debt securities are typically structured as notes and issued in different tranches to investors. The tranches offer different priority of payments subject to a “waterfall” and defined levels of risk with upside participation caps or limits, which are compensated through the payment of increasing coupon rates on the more subordinated notes. Unlike investors in other private funds, the noteholders are similarly situated with all of the other noteholders in the same tranche and they cannot redeem or “cash in” their note ahead of other noteholders in the same tranche. As a result, in our experience, this structure has generally deterred investors from requesting, and SAF advisers from granting, preferential treatment. Thus, we do not believe that preferential treatment for SAFs presents the same conflicts of interest and investor protection concerns as it does for non-SAF funds.

We also believe that the quarterly statement would generally not provide meaningful information for SAF investors. For example, some commenters highlighted that the performance information required to be included in private fund quarterly statements would generally not constitute relevant or useful information for SAF investors, because the performance of a SAF, as a cash flow investment vehicle, primarily depends on the cash proceeds it realizes from its portfolio assets, as opposed to an increase in the value of its portfolio assets.<sup>165</sup> These commenters stated that, instead of the performance metrics required for liquid or illiquid funds

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<sup>165</sup> See LSTA Comment Letter; SFA Comment Letter I; SIFMA-AMG Comment Letter I; TIAA Comment Letter.

under the rules, a yield performance metric and/or information regarding the SAF's cash distributions to investors (as well as its ability to make future cash distributions) would more appropriately reflect the specific cash flow structure of a SAF investment; and these commenters pointed out that SAF investors already receive this information, which is generally required to be periodically reported to investors in detail in accordance with a SAF's securitization transaction agreement. We agree with commenters that the required performance metrics would be less useful to SAF investors than they are for non-SAF investors, particularly in light of the detailed information that SAF investors are generally already required to receive. For example, because the performance reporting would report performance at the SAF level, but investors sit in different tranches along the SAF's distribution waterfall with different risk/return profiles, the required performance reporting would likely be uninformative with respect to any specific tranche.

As another example, the "distribution" requirements under the final rules would likely be impracticable for most SAF advisers. Unlike other private funds that are primarily purchased, with respect to U.S. persons, through a primary issuance pursuant to Regulation D, which generally restricts a security's transferability and does not contemplate an investor's resale of the security to a third party, SAF interests are primarily purchased in the United States through a primary issuance and subsequently resold and traded on the secondary market by qualified institutional buyers pursuant to Regulation 144A. Because SAF interests are, unlike interests in other types of private funds, primarily traded on the secondary market, the interests are generally held in street name by broker-dealers on behalf of the fund's investors, who are, accordingly, not generally known by the fund or its investment adviser. To address delivery obligations under the fund documents, a SAF's independent collateral administrator typically establishes a website that

is accessible by noteholders where their required reports are furnished, in accordance with the terms of the securitization transaction agreement. As a result, a SAF adviser may not have the necessary contact information for each noteholder of the SAF to satisfy the distribution requirements.

Finally, SAF advisers often have a more limited role in the management of a private fund, and SAFs or their sponsors typically engage more independent service providers than non-SAF funds. The primary role of an adviser to a SAF is, in many cases, to select and monitor the fund's pool of assets in compliance with certain portfolio requirements and quality tests (such as overcollateralization, diversification, and interest coverage tests) that are set forth in the fund's securitization transaction agreements. In many cases, the SAF's transaction agreement appoints an independent trustee to serve as custodian for the underlying investments. The trustee and collateral administrator are typically responsible for preparing detailed monthly and quarterly reports for the investors regarding the SAF's assets and expenses. We believe that these structural protections provide an important check on the adviser's activity or otherwise limit the actions the adviser can take to harm investors.

For the reasons described above, we believe it is appropriate not to apply all five private fund adviser rules to advisers with respect to SAFs they advise.

## **B. Quarterly Statements**

Section 211(h)(1) of the Act states that the Commission shall facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest. The quarterly statement rule is designed to facilitate the provision of simple and clear disclosures to investors regarding some of the most important and fundamental terms of their relationships with

investment advisers to private funds in which those investors invest—namely what fees and expenses those investors will pay and what performance they receive on their private fund investments. These disclosures will allow investors to better understand their private fund investments and the terms of their relationship with the adviser to those funds.

Several commenters stated that section 211(h)(1) of the Act does not authorize the quarterly statement rule because details about past performance of funds and fees paid to the adviser are not terms of the relationship between investors and advisers.<sup>166</sup> However, section 211(h)(1) of the Act does not limit a “term” of the relationship only to the provisions in a contract, as these commenters assert.<sup>167</sup> In the private fund context, it is the adviser or its affiliated entities that generally draft the private fund’s private placement memorandum and governing documents,<sup>168</sup> negotiate fund terms<sup>169</sup> with the private fund investors, manage the fund, charge and/or allocate fees and expenses to the private fund which are then paid by the private fund investors, and calculate and present performance information to the private fund investors. In this context, fees and performance are essential to the relationship between an investor and an adviser. The method used to calculate fees is typically set forth in the fund contracts. However, based on Commission staff experience, fee and performance disclosures are often not simple or clear, and investors may have difficulty understanding them. As a result,

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<sup>166</sup> See, e.g., AIC Comment Letter I; Comment Letter of the National Venture Capital Association (Apr. 25, 2022) (“NVCA Comment Letter I”); Citadel Comment Letter.

<sup>167</sup> See, e.g., AIC Comment Letter I; Citadel Comment Letter

<sup>168</sup> Including, for many types of private funds, the private fund operating agreement to which the adviser or its affiliate and the private fund investors are typically both parties.

<sup>169</sup> Such fund terms include, for example, the formulas that determine the amount of carried interest and management fees paid to the adviser in addition to other key terms such as the length of the life of the fund and the mechanics of fund governance.

advisers have overcharged certain fees without investors recognizing it immediately.<sup>170</sup>

Similarly, performance is a crucial term of the relationship between an adviser and investors.

Performance is implicitly or explicitly part of the terms of many fund contracts to the extent that advisers are often compensated in part based on the performance of the private fund.<sup>171</sup> The amount, calculation, and timing of performance compensation are often negotiated by the adviser and the investors and form the core economic term of their relationship.

Calculating performance is also complicated, and methods generally differ among advisers. Without comparable performance metrics and methodologies, it can be unclear how different advisers perform against one another. Performance calculations also generally are the product of many assumptions and criteria, such as the manner in which management fee rates are applied. Without simple and clear disclosures of such assumptions and criteria, investors are at a disadvantage with respect to understanding or being able to verify how their investments are performing.<sup>172</sup>

Section 206(4) of the Act gives the Commission the authority to prescribe means reasonably designed to prevent fraud, deception, and manipulation. The quarterly statement rule is reasonably designed to prevent fraud, deception, and manipulation because it requires advisers to provide timely and consistent disclosures that will improve the ability of investors to assess

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<sup>170</sup> See, e.g., *In re Global Infrastructure Management, LLC*, *supra* footnote 30 (alleging private fund adviser failed to properly offset management fees to private equity funds it managed and made false and misleading statements to investors and potential investors in those funds concerning management fee offsets); *In the Matter of ECP Manager LP*, Investment Advisers Act Release No. 5373 (Sept. 27, 2019) (settled action) (alleging that private equity fund adviser failed to apply the management fee calculation method specified in the limited partnership agreement by failing to account for write downs of portfolio securities causing the fund and investors to overpay management fees).

<sup>171</sup> This includes the private fund operating agreement to which the adviser or its affiliate and private fund investors are typically both parties.

<sup>172</sup> Put simply, performance is key to the terms of the relationship between private fund investors and advisers because private fund investors pay advisers to seek to generate investment returns, and performance information allows investors to assess how an adviser is fulfilling that obligation.

and monitor fees, expenses, and performance. This will decrease the likelihood that investors will be defrauded, deceived, or manipulated because they will be in a better position to monitor the adviser and their respective investments, and it increases the likelihood that any such misconduct will be detected sooner.<sup>173</sup> Moreover, the fee, expense and performance information in the quarterly statement will improve investors' ability to evaluate the adviser's conflicts of interest with respect to the fees and expenses charged to the fund by the adviser and the performance metrics that the adviser presents to investors.<sup>174</sup>

Several commenters stated that Commission, in the proposal, failed to define a fraudulent, deceptive, or manipulative act as required by section 206(4) of the Act.<sup>175</sup> Another commenter stated that the Commission, in the proposal, failed to connect the proposed reporting requirements to any actual fraudulent act.<sup>176</sup> To the contrary, the quarterly statement is designed to prevent fraudulent, deceptive, or manipulative practices, including ones we have observed.<sup>177</sup> For example, if an adviser is charging investors a management fee and simultaneously charging a

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<sup>173</sup> See *infra* footnotes 177-178 (providing examples of misconduct relating to fees, expenses, and performance).

<sup>174</sup> See *supra* section I (discussing conflicts of interest).

<sup>175</sup> See, e.g., AIC Comment Letter I; NVCA Comment Letter.

<sup>176</sup> See Citadel Comment Letter.

<sup>177</sup> See, e.g., *In the Matter of Sabra Capital Partners, LLC and Zvi Rhine*, Investment Advisers Act Release No. 5594 (Sept. 25, 2020) (settled order) (alleging that, among other things, an investment adviser misrepresented the performance of a fund it advised in updates sent to the fund's limited partners); *In the Matter of Finser International Corporation and Andrew H. Jacobus*, Investment Advisers Act Release No. 5593 (Sept. 24, 2020) (settled order) (alleging that, among other things, an investment adviser charged a fund it advised performance fees contrary to representations made in the fund's private placement memorandum); *In the Matter of Omar Zaki*, Investment Advisers Act Release No. 5217 (Apr. 1, 2019) (settled order) (alleging that, among other things, an investment adviser repeatedly misled investors in a fund it advised about fund performance); *In the Matter of Corinthian Capital Group, LLC, Peter B. Van Raalte, and David G. Tahan*, Investment Advisers Act Release No. 5229 (May 6, 2019) (settled order) (alleging that, among other things, an investment adviser failed to apply a fee offset to a fund it advised and caused the same fund to overpay organizational expenses); *In the Matter of Aisling Capital LLC*, Investment Advisers Act Release No. 4951 (June 29, 2018) (settled order) (alleging an investment adviser failed to apply a specified fee offset to a fund it advised contrary to the fund's limited partnership agreement and private placement memorandum).

portfolio company a monitoring or similar fee without disclosing that fee to investors, we would view that as fraudulent or deceptive because it involves an undisclosed conflict in breach of fiduciary duty.<sup>178</sup> Similarly, if an adviser is knowingly using off-market assumptions (such as highly irregular valuation practices that are not used by similarly-situated advisers) when calculating performance without disclosing such to investors, we would view that practice as deceptive.

The rule requires an investment adviser that is registered or required to be registered with the Commission to prepare a quarterly statement that includes certain information regarding fees, expenses, and performance for any private fund that it advises and distribute the quarterly statement to the private fund's investors, unless a quarterly statement that complies with the rule is prepared and distributed by another person.<sup>179</sup> If the private fund is not a fund of funds, then a quarterly statement must be distributed within 45 days after the end of each of the first three fiscal<sup>180</sup> quarters of each fiscal year and 90 days after the end of each fiscal year.<sup>181</sup> If the private fund is a fund of funds, then a quarterly statement must be distributed within 75 days after the first, second, and third fiscal quarter ends and 120 days after the end of the fiscal year of the private fund.

Many commenters supported the quarterly statement rule as proposed and agreed that it would provide increased transparency to private fund investors who may not currently receive sufficiently detailed, comprehensible, or regular fee, expense, and performance information for

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<sup>178</sup> See, e.g., *In the Matter of Monomoy Capital Management, L.P.*, Investment Advisers Act Release No. 5485 (Apr. 22, 2020) (settled action); *In the Matter of WCAS Management Corporation*, Investment Advisers Act Release No. 4896 (Apr. 24, 2018) (settled action); *In the Matter of Fenway Partners, LLC, et. Al.*, Investment Advisers Act Release No. 4253 (Nov. 3, 2015) (settled action).

<sup>179</sup> Final rule 211(h)(1)-2.

<sup>180</sup> See *infra* section II.B.3 for a discussion of the change to fiscal time periods for the quarterly statement rule.

<sup>181</sup> Final rule 211(h)(1)-2.

each of their private fund investments.<sup>182</sup> These commenters generally indicated that the quarterly statement rule would provide increased comparability between private funds and accordingly would enable private fund investors to make more informed investment decisions, as well as potentially lead to increased competitive market pressures on the costs of investing in private funds. Some commenters indicated that the rule’s establishment of a required baseline of recurring reporting would allow investors to focus their negotiation priorities with private fund advisers on other matters, such as fund governance, and could also provide investors with greater confidence when choosing to allocate capital to private fund investments.<sup>183</sup> One commenter suggested that the quarterly statement requirement would particularly help smaller or less sophisticated investors who may receive less timely or complete information than investors that possess greater negotiating power.<sup>184</sup> Other commenters did not support this quarterly statement rule (or parts of the rule, as discussed below).<sup>185</sup> Of these commenters, a number suggested that this quarterly statement requirement would increase costs for private funds that would ultimately be passed on to investors.<sup>186</sup> Some commenters stated that the quarterly statement rule may not

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<sup>182</sup> See, e.g., Comment Letter of National Education Association and American Federation of Teachers (Apr. 12, 2022) (“NEA and AFT Comment Letter”); Comment Letter of the American Federation of Teachers New Mexico (Apr. 12, 2022) (“AFT NM Comment Letter”); Comment Letter of the National Conference on Public Employee Retirement Systems (Apr. 25, 2022) (“NCPERS Comment Letter”); Better Markets Comment Letter; Comment Letter of Ohio Federation of Teachers (Apr. 25, 2022) (“OFT Comment Letter”); Comment Letter of American Federation of State, County and Municipal Employees (Apr. 25, 2022) (“AFSCME Comment Letter”); Consumer Federation of America Comment Letter; Public Citizen Comment Letter; Comment Letter of National Council of Real Estate Investment Fiduciaries (Apr. 25, 2022) (“NCREIF Comment Letter”); Comment Letter of New York State Insurance Fund (Apr. 25, 2022) (“NYSIF Comment Letter”); NYC Comptroller Letter; Comment Letter of AFL-CIO (Apr. 25, 2022) (“AFL-CIO Comment Letter”); Comment Letter NASAA Comment Letter.

<sup>183</sup> See, e.g., DC Retirement Board Comment Letter; ILPA Comment Letter I; Comment Letter of National Electrical Benefit Fund Investments (Apr. 25, 2022) (“NEBF Comment Letter”); OPERS Comment Letter.

<sup>184</sup> See Healthy Markets Comment Letter I.

<sup>185</sup> See, e.g., Comment Letter of Andreessen Horowitz (June 15, 2022) (“Andreessen Comment Letter”); NVCA Comment Letter; SIFMA-AMG Comment Letter I.

<sup>186</sup> See, e.g., IAA Comment Letter II; AIC Comment Letter I; Comment Letter of Roubaix Capital (Apr. 12, 2022) (“Roubaix Comment Letter”).



provide meaningful information or would confuse investors because the required information would not be personalized to investors, may not be appropriate for certain types of private funds, or may differ from other information already provided to private fund investors.<sup>187</sup> Other commenters stated that the rule is unnecessary and duplicative, as advisory firms already provide similar or otherwise sufficient reporting, and investors are generally able to negotiate for and receive additional disclosure that may be appropriate for their particular needs.<sup>188</sup>

As stated elsewhere, we have observed that private fund investments are often opaque; advisers frequently do not provide investors with sufficiently detailed information about private fund investments.<sup>189</sup> Without sufficiently clear, comparable information, even sophisticated investors may be unable to protect their interests or make sound investment decisions. Accordingly, we are adopting the quarterly statement rule, in part, because of the lack of transparency in key areas including private fund fees and expenses, performance, and conflicts of interest.

While we acknowledge that quarterly statements may increase costs, we believe these costs are justified in light of the benefits of the rule.<sup>190</sup> As discussed above, investors will benefit from increased transparency into the fees and expenses charged to the fund, as well as the

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<sup>187</sup> See, e.g., AIC Comment Letter I; IAA Comment Letter II; Ropes & Gray Comment Letter.

<sup>188</sup> See, e.g., AIMA/ACC Comment Letter; Comment Letter of Dechert LLP (Apr. 25, 2022) (“Dechert Comment Letter”); AIC Comment Letter I. One commenter stated that the Commission made no attempt to review the investor disclosures provided by open-end funds in order to evaluate whether the proposal would meaningfully increase transparency. See Citadel Comment Letter. On the contrary, Commission staff regularly reviews open- and closed-end fund investor disclosures as part of the Commission’s examination program and that experience informs this rulemaking. See, e.g., OCIE National Examination Program Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020) (“EXAMS Private Funds Risk Alert 2020”), available at [https://www.sec.gov/files/Private%20Fund%20Risk%20Alert\\_0.pdf](https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf). As of Dec. 17, 2020, the Office of Compliance, Inspections and Examinations (“OCIE”) was renamed the Division of Examinations (“EXAMS”).

<sup>189</sup> See Proposing Release *supra* footnote 3, at n.9-11.

<sup>190</sup> See *infra* section VI.D.2.

conflicts they present, on a timely basis. Investors will also benefit from mandatory timely updates regarding fund performance if they were not already receiving them.<sup>191</sup> We also disagree with commenters' concerns regarding quarterly statements failing to provide meaningful information. The quarterly statement will present a baseline level of information in a clear format and will help private fund investors to monitor and assess the true cost of their investments better. For example, the enhanced cost information may allow an investor to identify when the private fund has incorrectly, or improperly, assessed a fee or expense by the adviser. We also disagree with certain commenters' concerns that the quarterly statement may not be appropriate for certain types of private funds. We believe that the fee, expense, and performance information required in the quarterly statement is a fundamental disclosure that is relevant to all types of private funds.

Moreover, we anticipate the costs of compliance with this rule may be of limited magnitude in light of the fact that many private fund advisers already maintain and, in many cases, already disclose similar information to investors.<sup>192</sup> Relatedly, we acknowledge that many private fund advisers contractually agree to provide fee, expense, and performance reporting to investors already. However, not all private fund investors are able to obtain this information. Other investors may be able to obtain relevant information, but the information may not be sufficiently clear or detailed regarding the costs and performance of a particular private fund to enable an investor to understand, monitor and make informed investment decisions regarding its

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<sup>191</sup> Furthermore, even if investors are already receiving timely updates regarding fund performance for the funds in which they are currently invested, they may also benefit from no longer needing to expend resources negotiating for it for funds in which they wish to invest in the future. As the quarterly statement rule requires this baseline of performance information, investors will be able to focus their resources on negotiating for more bespoke reporting or other important rights in new funds.

<sup>192</sup> See *infra* sections VI.C.3, VI.D.2.

private fund investments. For instance, some advisers report only aggregated expenses, or do not provide detailed information about the calculation and implementation of any negotiated rebates, credits, or offsets, which does not allow an investor to identify the actual extent and/or types of costs incurred and to evaluate their validity. Other investors may not have sufficient information regarding private fund fees and expenses in part because those fees and expenses have varied presentations across private funds and are subject to complicated calculation methodologies, which similarly prevents an investor from meaningfully assessing those fees and expenses and comparing private fund investments. Private fund investors are increasingly interested in more disclosure regarding private fund performance, including transparency into the calculation of the performance metrics.<sup>193</sup> Providing investors with simple and clear disclosures regarding fees, expenses, and performance will allow investors to understand better their private fund investments and the terms of their relationship with the adviser.<sup>194</sup>

We also disagree with commenters that suggested the quarterly statement would confuse investors. For example, some commenters asserted that standardized quarterly statement disclosures could confuse investors because the required information may not reflect an investor's actual, particularized investment experience in a fund.<sup>195</sup> However, investors will benefit from receiving a baseline level of simple and clear disclosures regarding fee, expenses, and performance. For example, private fund advisers currently use different metrics and

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<sup>193</sup> See, e.g., GPs feel the strain as LPs push for more transparency on portfolio performance and fee structures, Intertrust Group (July 6, 2020), *available at* <https://www.intertrustgroup.com/news/gps-feel-the-strain-as-lps-push-for-more-transparency-on-portfolio-performance-and-fee-structures/>; ILPA Principals 3.0, (2019), at 36 “Financial and Performance Reporting” and “Fund Marketing Materials,” *available at* <https://ilpa.org/wp-content/flash/ILPA%20Principles%203.0/?page=36>.

<sup>194</sup> Section 211(h)(1) of the Advisers Act directs the Commission to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment advisers.

<sup>195</sup> See, e.g., AIC Comment Letter I; IAA Comment Letter II.

specifications for calculating performance, which makes it difficult for investors to compare information across funds and advisers, even when advisers disclose the assumptions they used. More standardized requirements for performance metrics will allow private fund investors to compare more easily the returns of similar fund strategies over different market environments and over time. Simple and clear information about costs and performance that is provided on a regular basis will help an investor better decide whether to continue the terms of its relationship with the adviser, whether to remain invested in a particular private fund where the fund allows for withdrawals and redemptions, whether to invest in private funds managed by the adviser or its related persons in the future, and how to invest other assets in the investor's portfolio.

Certain commenters argued that the quarterly statement requirement would be particularly burdensome for small and emerging advisers.<sup>196</sup> We first observe that the quarterly statement rule is only applicable to investment advisers that are registered or required to be registered with the Commission. Thus, some private fund advisers, including those solely advising less than \$150 million private fund assets under management and those with less than \$100 million in regulatory assets under management registered with, and subject to examination by the States, will not be subject to the quarterly statement rule. Second, we understand that firms vary in the extent to which they devote resources specifically to compliance. It is important for all investors in private funds advised by SEC-registered advisers to receive sufficiently detailed, comprehensible, and regular information to enable investors to monitor whether fees and expenses are being mischarged and to ensure that accurate performance information is being clearly presented. We view sufficient fee, expense, and performance information under the rule as together forming, and each as an essential component of, the basic

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<sup>196</sup> See, e.g., AIC Comment Letter I; Lockstep Ventures Comment Letter; SBAI Comment Letter.

set of information that is generally necessary for private fund investors to evaluate accurately and confidently their private fund investments. Accordingly, we are not providing any exemptions to the quarterly statement rule for small or emerging advisers.

In addition to general comments on the proposed quarterly statement rule, commenters made specific suggestions or sought clarification on discrete parts of the proposal.<sup>197</sup> One commenter asked the Commission to clarify that investors may negotiate reporting in addition to what is required in the quarterly statements.<sup>198</sup> We confirm that the quarterly statements represent a baseline level of reporting that is required for covered private fund advisers. The quarterly statement rule itself does not restrict or limit the kinds of additional reporting for which private fund investors may negotiate.

Some commenters suggested that we require investor-specific or class-specific reporting in addition to fund-level reporting.<sup>199</sup> While we recognize the utility to investors of investor-level reporting, we do not believe that requiring investor-level reporting in quarterly statements is essential to this rulemaking. First, the quarterly statements are designed, in part, to allow individual private fund investors to use fund-level information to perform the types of personalized or otherwise customized calculations that underlie investor-specific reporting. Second, we understand that, even if private fund advisers provide investors with investor-specific reporting, many investors would still need to perform personalized or otherwise customized

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<sup>197</sup> One commenter requested the Commission clarify that a registered U.S. sub-adviser would not need to comply with the quarterly statement rule with respect to a private fund whose primary adviser is not subject to the rule. *See* AIMA/ACC Comment Letter. However, the final rule does not include an exception for such advisers. We believe that the requested exception would diminish the effectiveness of the rule, as the fact that one adviser may not be subject to the final rule does not negate the need for the private fund and its underlying investors to receive the benefit of a quarterly statement.

<sup>198</sup> *See* NYC Comptroller Comment Letter.

<sup>199</sup> *See, e.g.,* ILPA Comment Letter I; Healthy Markets Comment Letter I; OPERS Comment Letter; NYSIF Comment Letter.

calculations to satisfy their own internal requirements.<sup>200</sup> Third, the fund-level reporting requirements do not prevent an adviser from providing (or causing a third party, such as an administrator, consultant, or other service provider, to provide) personalized information, as well as other customized information, to supplement the standardized baseline level (*i.e.*, the mandatory floor) of fund-level information required to be included in the quarterly statements, provided that such additional information complies with the other requirements of the final rule, the marketing rule,<sup>201</sup> and other disclosure requirements, each to the extent applicable. We are requiring what we view as essential baseline, fund-level information, allowing investors to focus their time and bargaining resources on requests for any more personalized information they may need, which may vary from investor to investor.

Similarly, while we recognize the value of class-level reporting, requiring class-level reporting on quarterly statements is not necessary for the same reasons as those discussed above for investor-specific reporting. Additionally, requiring class-level reporting would not increase comparability across different advisers. For example, an investor might be in substantially different classes in funds advised by different advisers and thus might have difficulty comparing class-level reporting across these funds.<sup>202</sup>

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<sup>200</sup> For example, an investor may seek to analyze the performance of each of a fund's individual portfolio investments to better understand the nature of such fund's performance as well as the adviser's skill at investment selection and management at a more granular level.

<sup>201</sup> See rule 206(4)-1. A communication to a current investor can be an "advertisement," for example, when it offers new or additional investment advisory services with regard to securities.

<sup>202</sup> Any class-based assumptions or criteria used to calculate fund-level performance should be prominently disclosed as part of the quarterly statements. For example, if an adviser uses a management fee rate that is averaged across different classes to compute fund-level performance, it should be prominently disclosed in the quarterly statement. See *infra* section II.B.2.c.

Commenters suggested that we should allow investors to waive this quarterly statement requirement.<sup>203</sup> However, if we were to allow investors to waive the quarterly statement requirement, then some private fund advisers may require investors to do so as a precondition to investing in a fund. Furthermore, even if a private fund adviser does not explicitly require such a waiver as a precondition to investment, a private fund adviser could attempt to anchor negotiations around a waiver by including one in a private fund’s subscription agreement and thereby compelling investors to choose between expending resources to negotiate for quarterly statements or for other important terms related to fund governance and investor protection. Such an outcome would undermine improving transparency for these private fund investors and would fail to address the harms that the rule is intended to address.

Some commenters suggested requiring statements annually instead of quarterly.<sup>204</sup> Other commenters suggested requiring statements semi-annually.<sup>205</sup> Another commenter suggested requiring these statements more frequently than quarterly for liquid funds as many liquid funds currently provide monthly statements.<sup>206</sup> It is our understanding that most private funds (liquid and illiquid) report at least quarterly. Accordingly, we believe that requiring quarterly reporting is well suited to enhance investors’ ability to compare performance as well as fee and expense information across liquid and illiquid private funds because many private investors are accustomed to receiving and reviewing quarterly reports. Monthly or more frequent reporting may also not provide sufficiently more meaningful information to justify imposing the burdens

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<sup>203</sup> See, e.g., BVCA Comment Letter; Comment Letter of the German Private Equity and Venture Capital Association (June 2, 2022) (“GPEVCA Comment Letter”).

<sup>204</sup> See, e.g., Schulte Comment Letter; Invest Europe Comment Letter; BVCA Comment Letter.

<sup>205</sup> See, e.g., Ropes & Gray Comment Letter; MFA Comment Letter I; AIMA/ACC Comment Letter.

<sup>206</sup> See RFG Comment Letter II.

for private funds that do not already provide such frequent reporting.<sup>207</sup> All private funds, including liquid funds, may provide additional reporting on a more frequent basis than quarterly. On the other hand, we believe that annual or semi-annual statements are too infrequent and such infrequency would make it difficult for investors to monitor their investments. Receiving a year or six months' worth of fee and expense information at one time would make it more burdensome for investors to parse (particularly, because some of those outlays may be a year or six months old) and to help ensure that fees are being charged appropriately. Similarly, because a fund's performance can change drastically over the course of a year or six months, investors often need more frequent and regular performance reporting to make informed investment decisions and to balance their own portfolio. We believe that quarterly reporting strikes the right balance between sufficient frequency to enable investor analysis and decision making and mitigation of burdens on advisers.

### **1. Fee and Expense Disclosure**

The rule requires an investment adviser that is registered or required to be registered to prepare and distribute quarterly statements for any private fund that it advises with certain information regarding the fund's fees and expenses and any compensation paid or allocated to the adviser or its related persons by the fund, as well as any compensation paid or allocated by the fund's underlying portfolio investments. The statement will provide investors in those funds with comprehensive fee and expense disclosure for the prior quarterly period (or, in the case of a

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<sup>207</sup> For example, it is our understanding that the majority of private equity funds currently provide quarterly reporting. Since private equity funds generally invest on a longer time horizon, we do not expect that monthly reporting would inherently provide more beneficial information for investors than quarterly reporting and it would entail substantial additional administrative costs.



newly formed private fund’s initial quarterly statement, its first two full fiscal quarters of operating results).

Many commenters generally supported the fee and expense disclosure requirement for the quarterly statements and agreed that establishing a standardized baseline level (*i.e.*, a “floor”) of fee and expense disclosure would enhance the basic transparency, comparability and investors’ understanding and oversight of their private fund investments.<sup>208</sup> Some commenters criticized it on various grounds, as discussed in more detail below, including that the fee and expense disclosure requirement as proposed would be overly broad, costly, and burdensome.<sup>209</sup> Certain commenters relatedly suggested that current fee and expense disclosure practices are sufficient because investors can already negotiate for the types of reporting that would meet their needs.<sup>210</sup>

Although the required fee and expense disclosure in the quarterly statement will impose some additional costs, it is essential that investors receive this information in a timely, detailed, and consistent manner. Private funds are often more expensive than other asset classes because the scope and magnitude of fees and expenses paid directly and indirectly by private fund investors can be extensive and complex. Although the types of fees and expenses charged to

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<sup>208</sup> See, e.g., ILPA Comment Letter I; Comment Letter of the Council of Institutional Investors (Apr. 7, 2022) (“CII Comment Letter”); Comment Letter of the Seattle City Employees’ Retirement System (Apr. 19, 2022) (“Seattle Retirement System Comment Letter”); OFT Comment Letter; United for Respect Comment Letter I; Public Citizen Comment Letter; Comment Letter of the Los Angeles County Employees Retirement Association (July 28, 2022) (“LACERA Comment Letter”); OPERS Comment Letter; NCPERS Comment Letter; Comment Letter of Take Medicine Back (Apr. 25, 2022) (“Take Medicine Back Comment Letter”); Comment Letter of Segal Marco Advisors (Apr. 25, 2022) (“Segal Marco Comment Letter”); Comment Letter of the Illinois State Treasurer (May 12, 2022) (“IST Comment Letter”); AFL-CIO Comment Letter; Comment Letter of Morningstar, Inc. (Apr. 25, 2022) (“Morningstar Comment Letter”); Comment Letter of CFA Institute (June 24, 2022) (“CFA Comment Letter II”).

<sup>209</sup> See, e.g., Comment Letter of Impact Capital Managers, Inc. (Apr. 25, 2022) (“ICM Comment Letter”); MFA Comment Letter I; Comment Letter of Americans for Tax Reform (Apr. 23, 2022) (“ATR Comment Letter”).

<sup>210</sup> See ICM Comment Letter; AIMA/ACC Comment Letter; Dechert Comment Letter; AIC Comment Letter I.

private funds can vary across the industry, investors typically compensate the adviser for managing the affairs of a private fund, often in the form of management fees<sup>211</sup> and performance-based compensation.<sup>212</sup> A fund's portfolio investments also may pay fees to the adviser or its related persons.<sup>213</sup> The quarterly statement will help ensure disclosure of these fees and expenses, and the corresponding dollar amounts, to current investors on a consistent and regular basis, which will allow investors to understand and assess the cost of their private fund investments.

We disagree with the suggestion from some commenters that current fee and expense disclosure practices are sufficient. We understand that some fund investors have struggled to obtain complete and usable expense information, including when institutionally required to do so, for example, by the laws applicable to State and municipal plan investors.<sup>214</sup> Many investors also generally lack transparency regarding the total cost of fees and expenses.<sup>215</sup> For instance, even though investors can indirectly end up bearing the costs associated with a portfolio

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<sup>211</sup> Certain private fund advisers utilize a pass-through expense model where the private fund pays for most, if not all, expenses, including the adviser's expenses, but the adviser does not charge a management fee. *See infra* section II.E.1. for a discussion of such pass-through expense models.

<sup>212</sup> Investors typically enter into agreements under which the private fund pays such compensation directly to the adviser or its affiliates. Investors generally bear such compensation indirectly through their investment in the private fund; however, certain agreements may require investors to pay the adviser or its affiliates directly.

<sup>213</sup> *See* Proposing Release, *supra* footnote 3, at 24-26 (describing the types of fees and expenses private fund investors typically pay or otherwise bear, including portfolio-investment level compensation paid to the adviser or its affiliates).

<sup>214</sup> *See, e.g.*, LACERA Comment Letter.

<sup>215</sup> *See* Hedge Fund Transparency: Cutting Through the Black Box, The Hedge Fund Journal, James R. Hedges IV (Oct. 2006), *available at* <https://thehedgefundjournal2006.com/hedge-fund-transparency/> (stating that "the biggest challenges facing today's hedge fund industry may well be the issues of transparency and disclosure"); Fees & Expenses, Private Funds CFO (Nov. 2020), at 12, *available at* <https://www.troutman.com/images/content/2/6/269858/PFCFO-FeesExpenses-Nov20-Final.pdf> (noting that it is becoming increasingly complicated for investors to determine what the management fee covers versus what is a partnership expense and stating that the "formulas for management fees are complex and unique to different investors."); *see also, e.g.*, ILPA Comment Letter I; For the Long Term Comment Letter; NCPERS Comment Letter; Comment Letter of Americans for Financial Reform Education Fund (Apr. 25, 2022) ("AFREF Comment Letter I").

investment paying fees to the adviser or its related persons, some advisers may not disclose the magnitude or scope of these fees to investors. Opaque reporting practices make it difficult for investors to measure and evaluate performance accurately, to assess whether an adviser's total fees are justified, and to make better informed investment decisions.<sup>216</sup> Moreover, opaque reporting practices may prevent private fund investors from assessing whether the types and amount of fees and expenses borne by the private fund comply with the fund's governing agreements or whether disclosures regarding fund fees and expenses accurately describe the adviser's practices or instead may be misleading. The Commission has brought enforcement actions related to the disclosure, misallocation and mischarging of fees and expenses by private fund advisers. For example, we have alleged in settled enforcement actions that advisers have received undisclosed fees,<sup>217</sup> received inadequately disclosed compensation from fund portfolio investments,<sup>218</sup> misallocated expenses away from the adviser to private fund clients,<sup>219</sup> mischarged a performance fee to a private fund client contrary to investor disclosures,<sup>220</sup> failed to offset certain fees or other amounts against management fees as set forth in fund

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<sup>216</sup> See, e.g., Letter from State Treasurers and Comptrollers to Mary Jo White, U.S. Securities and Exchange Commission (July 21, 2015), *available at* [http://comptroller.nyc.gov/wp-content/uploads/documents/SEC\\_SignOnPDF.pdf](http://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf); *see also* Letter from Americans for Financial Reform Education Fund to Chairman Gary Gensler, U.S. Securities and Exchange Commission (July 6, 2021), *available at* [https://ourfinancialsecurity.org/wp-content/uploads/2021/07/Letter-to-SEC-re\\_-Private-Equity-7.6.21.pdf](https://ourfinancialsecurity.org/wp-content/uploads/2021/07/Letter-to-SEC-re_-Private-Equity-7.6.21.pdf).

<sup>217</sup> See, e.g., *In the Matter of Blackstone*, *supra* footnote 26.

<sup>218</sup> See, e.g., *In the Matter of Monomoy Capital Management, L.P.*, Investment Advisers Act Release No. 5485 (Apr. 22, 2020) (settled action).

<sup>219</sup> See, e.g., *In the Matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC*, *supra* footnote 26; *In the Matter of Yucaipa Master Manager, LLC*, Investment Advisers Act Release No. 5074 (Dec. 13, 2018) (settled action).

<sup>220</sup> See, e.g., *In the Matter of Finser International Corporation, et al.*, Investment Advisers Act Release No. 5593 (Sept. 24, 2020) (settled action).

documents,<sup>221</sup> and directly or indirectly misallocated fees and expenses among private fund and other clients.<sup>222</sup> Commission staff has observed similarly problematic practices in its examinations of private fund advisers.<sup>223</sup> For example, Commission staff has observed advisers that charge private funds for expenses not permitted under the fund documents.<sup>224</sup> Commission staff has also observed advisers allocating expenses, such as broken-deal, due diligence, and consultant expenses, among private fund clients, other clients advised by an adviser or its related persons, and their own accounts in a manner that was inconsistent with disclosures to investors.<sup>225</sup> Investors are less able to monitor effectively whether such fee and expense misallocations are occurring and to respond effectively to this information without sufficiently timely, regular, and detailed fee and expense information.

Some commenters suggested requiring an expense ratio to help provide context as to the relative magnitude of a fund's expenses.<sup>226</sup> Although expense ratios may be helpful in certain circumstances in providing a top-line cost figure, they may be less helpful in others. For instance, if an adviser is misallocating certain smaller expenses, an expense ratio may obscure this practice if overall changes to the top-line cost figure are not obvious. Additionally, expense ratios may fail to capture some of the nuances of private fund fee and expense structures, such as with respect to the current and future impact of offsets, rebates and waivers, and investors might

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<sup>221</sup> See, e.g., *In the Matter of Corinthian Capital Group, LLC, et al.*, Investment Advisers Act Release No. 5229 (May 6, 2019) (settled action).

<sup>222</sup> See, e.g., *In the Matter of Lincolnshire*, *supra* footnote 26 (alleging that an investment adviser that misallocated expenses between its private funds' portfolio companies and violated its fiduciary duty to the private funds); *In the Matter of Rialto Capital Management, LLC*, Investment Advisers Release No. 5558 (Aug. 7, 2020) (settled action); *In the Matter of Energy Capital Partners*, *supra* footnote 30.

<sup>223</sup> See EXAMS Private Funds Risk Alert 2020, *supra* footnote 188.

<sup>224</sup> See *id.*

<sup>225</sup> See *id.*

<sup>226</sup> See MFA Comment Letter I; NCREIF Comment Letter.

not otherwise receive sufficient disclosure on such fee and expense structures. The focus of this disclosure requirement is to require a private fund adviser to provide its private fund investors regularly and in a timely manner with at least a baseline level of consistent and detailed fee and expense information, so that private fund investors are generally better able to assess and monitor effectively the costs of investing in private funds managed by the adviser.<sup>227</sup> If investors receive this information reliably, they will be better able to calculate their own applicable expense ratios.

Furthermore, as stated above, advisers under the rule will remain able to provide, and investors are free to request and negotiate for, disclosure of expense ratios, as well as other information, to supplement the standardized baseline level (*i.e.*, the mandatory floor) of fund fee and expense disclosure required in the quarterly statements, provided that such additional information complies with the other requirements of the final rule, the marketing rule,<sup>228</sup> and other disclosure requirements, each to the extent applicable.

**a) Private Fund-Level Disclosure**

The quarterly statement rule will require private fund advisers to disclose the following information to investors in a table format:

(1) A detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the private fund (“adviser compensation”) during the reporting period;

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<sup>227</sup> Although certain kinds of expense ratios are required in the registered funds context, we understand that fees and expenses are more likely to vary over time in the private fund space. For example, a private equity fund may incur a disproportionate amount of expenses early in its life when it is making the majority of its investments and incur fewer expenses during the middle part of its life when it is focused on holding these investments. The use of an expense ratio in these periods may overstate or understate, respectively, the expense burdens over the life of the fund.

<sup>228</sup> See *supra* footnote 201.

(2) A detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period other than those listed in paragraph (1) above (“fund expenses”); and

(3) The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons.<sup>229</sup>

The table is designed to provide investors with comprehensive fund fee and expense disclosure for the prior quarterly period (or, in the case of a newly formed private fund’s initial quarterly statement, its first two full fiscal quarters of operating results).<sup>230</sup> We discuss each of these elements in turn below.

*Adviser Compensation.* Substantially as proposed, the rule will require the fund table to show a detailed accounting of all adviser compensation during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, as proposed.<sup>231</sup> The rule is designed to 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, without permitting the exclusion of *de minimis* expenses, the general grouping of smaller expenses into broad categories, or the labeling of expenses as miscellaneous.

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<sup>229</sup> Final rule 211(h)(1)-2(b).

<sup>230</sup> See final rule 211(h)(1)-1 (defining “reporting period” as the private fund’s fiscal quarter covered by the quarterly statement or, for the initial quarterly statement of a newly formed private fund, the period covering the private fund’s first two full fiscal quarters of operating results). To the extent a newly formed private fund begins generating operating results on a day other than the first day of a fiscal quarter (*e.g.*, Jan. 1), the adviser should include such partial quarter and the immediately succeeding fiscal quarters in the newly formed private fund’s initial quarterly statement. For example, if a fund begins generating operating results on Feb. 1, the reporting period for the initial quarterly statement would cover the period beginning on Feb. 1 and ending on Sept. 30.

<sup>231</sup> Final rule 211(h)(1)-2(b)(1).

Many commenters generally supported the requirement to report adviser compensation on the quarterly statements.<sup>232</sup> Some commenters suggested that this requirement would be overly burdensome, in particular due to the breadth of certain aspects of the requirement (as discussed below), or that current market practices are sufficient.<sup>233</sup>

Many private funds compensate advisers with a “2 and 20” or similar arrangement, consisting of a 2% management fee and a 20% share of any profits generated by the fund. Certain advisers, however, receive other forms or amounts of compensation from private funds in addition to, or in lieu of, such arrangements.<sup>234</sup> Requiring advisers to disclose all forms of adviser compensation as separate line items without prescribing particular categories of fees is appropriate because this requirement will encompass the various and evolving forms of adviser compensation across the private funds industry.

In addition to compensation paid to the adviser, the rule requires the fund table to include disclosure of compensation, fees, and other amounts allocated or paid to the adviser’s “related persons.” We are defining “related persons” to include: (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser.<sup>235</sup> The term “control” is defined to mean the

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<sup>232</sup> See, e.g., CII Comment Letter; Seattle Retirement System Comment Letter; IST Comment Letter.

<sup>233</sup> See, e.g., ICM Comment Letter; Comment Letter of Alumni Ventures (Apr. 25, 2022) (“Alumni Ventures Comment Letter”); MFA Comment Letter I.

<sup>234</sup> See Proposing Release, *supra* footnote 3, at 28-29 (describing the types of adviser compensation private fund investors typically pay or otherwise bear).

<sup>235</sup> Final rule 211(h)(1)-1. Form ADV uses the same definition. The regulations at 17 CFR 275.206(4)-2 (rule 206(4)-2) use a similar definition by defining related person to include any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control with the adviser.

power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.<sup>236</sup> We are adopting both definitions as proposed.

Many advisers conduct a single advisory business through multiple separate legal entities and provide advisory services to a private fund through different affiliated entities or personnel. The “related person” and “control” definitions are designed to capture the various entities and personnel that an adviser may use to provide advisory services to, and receive compensation from, private fund clients. Some commenters supported broadening the “related person” and “control” definitions to include, for example, unaffiliated service providers that provide payments to an adviser or over which an adviser has economic influence, former personnel and family members, operational partners, senior advisors, or similar consultants of an adviser, a private fund, or its portfolio investments, and/or any recipient of fund management fees or performance-based compensation.<sup>237</sup> Other commenters supported adopting definitions that are consistent with advisers’ existing reporting obligations,<sup>238</sup> with one commenter suggesting that adopting different definitions could capture irrelevant persons or entities and create unnecessary

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<sup>236</sup> Final rule 211(h)(1)-1. The definition, in addition, provides that: (i) each of an investment adviser’s officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the investment adviser; (ii) a person is presumed to control a corporation if the person: (A) directly or indirectly has the right to vote 25% or more of a class of the corporation’s voting securities; or (B) has the power to sell or direct the sale of 25% or more of a class of the corporation’s voting securities; (iii) a person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the partnership; (iv) a person is presumed to control a limited liability company if the person: (A) directly or indirectly has the right to vote 25% or more of a class of the interests of the limited liability company; (B) has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the limited liability company; or (C) is an elected manager of the limited liability company; or (v) a person is presumed to control a trust if the person is a trustee or managing agent of the trust. Form ADV uses the same definition.

<sup>237</sup> See, e.g., Comment Letter of Convergence (Apr. 23, 2022) (“Convergence Comment Letter”); Comment Letter of XTP Implementation Services, Inc. (Apr. 25, 2022) (“XTP Comment Letter”).

<sup>238</sup> See, e.g., AIMA/ACC Comment Letter; SBAI Comment Letter; SIFMA-AMG Comment Letter I.



confusion.<sup>239</sup> We are adopting definitions that are consistent with the definitions of “related person” and “control” used on Form ADV and Form PF, which advisers already have experience assessing as part of their disclosure obligations on those forms, and which capture the entities and personnel that advisers typically use to conduct a single advisory business and provide advisory services to a private fund.

One commenter suggested that the rule’s reference to “sub-advisory fees” in the non-exhaustive list of compensation types covered by the adviser compensation disclosure requirement is inappropriate, because sub-advisory fees are generally not paid to the sub-adviser by a private fund and instead are often paid out of the management fee or other adviser compensation received by the fund’s primary adviser from the fund.<sup>240</sup> As proposed, the rule requires disclosure of any adviser compensation allocated or paid to the adviser or any of its related persons, including, without limitation, a related person that is a sub-adviser to the private fund, to the extent that the compensation to the related person is allocated or paid by the fund. Accordingly, the rule does not require sub-advisory fees allocated or paid to a related person solely by the fund’s adviser (and not by the fund) to be disclosed as a separate item of adviser compensation. Another commenter suggested that the rule should require disclosure of sub-

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<sup>239</sup> See AIMA/ACC Comment Letter.

<sup>240</sup> See *id.* This commenter also stated that disclosing sub-adviser fees separately could disincentivize sub-advisers from offering discounted or reduced fees to private funds. The final rule will not require separate disclosure of sub-adviser fees to the extent such fees are not paid by the fund, as discussed below. Nevertheless, this comment could also be understood to apply to any disclosure of sub-adviser compensation, including the disclosure of sub-adviser fees that are paid or allocated to the sub-adviser by the fund, which, as discussed below, will be required disclosure under the final rule. In this regard, although sub-adviser compensation, similar to any other adviser compensation, may be subject to upward or downward fee pressures as a result of the disclosure of compensation information, we believe that increased transparency and comparability with respect to the sub-adviser (and other adviser) compensation borne by a private fund is essential to generally enable private fund investors to make more informed investment decisions, and that this information could also lead to increased competitive market pressures on the costs of investing in private funds.

advisory fees to unrelated sub-advisers, in addition to related person sub-advisers.<sup>241</sup>

Compensation to unrelated sub-advisers is required to be separately disclosed as a fund fee and expense under 17 CFR 211(h)(1)-2(b)(2) (final rule 211(h)(1)-2(b)(2)), to the extent that such payments are allocated to or paid by the fund.

Substantially as proposed, we are defining “performance-based compensation” as allocations, payments, or distributions of capital based on a private fund’s (or its investments’) capital gains, capital appreciation, and/or profit.<sup>242</sup> Commenters generally did not provide comments with respect to the proposed definition of “performance-based compensation.” We are, however, making two non-substantive, technical changes to this definition. First, we are revising the definition to include not only capital gains and capital appreciation but also profit. This change will capture performance-based compensation that may be calculated based on other types or measures of investment performance, such as investment income. Second, the parenthetical in the definition now references “or any of its investments” rather than “or its portfolio investments,” because the value of the fund’s investment (*i.e.*, the value of the fund’s interest in a portfolio investment entity or issuer) will typically determine whether the adviser is entitled to performance-based compensation, rather than the value of the portfolio investment entity or issuer itself. The broad scope of this definition, which captures, without limitation, carried interest, incentive fees, incentive allocations, or profit allocations, among other forms of compensation, is appropriate in light of the various and evolving forms of performance-based compensation received by private fund advisers. This definition also covers both cash and non-

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<sup>241</sup> See NASAA Comment Letter.

<sup>242</sup> Final rule 211(h)(1)-1.

cash compensation, including, for example, allocations, payments, or distributions of performance-based compensation that are in-kind.

*Fund Fees and Expenses.* The rule requires the 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, substantially as proposed.<sup>243</sup> In a change from the proposal, we are revising this requirement to capture not only amounts “paid by” the private fund but also fees and expenses “allocated to” the private fund during the reporting period.<sup>244</sup> This clarification is necessary to avoid potentially misleading investors in light of the various ways that a private fund may be caused to bear fees and expenses. Additionally, this change is consistent with the requirement in rule 211(h)(1)-2(b)(1), as proposed and adopted, to disclose compensation *allocated* or paid to the adviser or any of its related persons by the private fund during the reporting period.

Similar to the approach taken with respect to adviser compensation discussed above, 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. The rule’s capturing of all, rather than limited categories of, fund fees and expenses is appropriate because this requirement will encompass the various and evolving forms of private fund fees and expenses. 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

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<sup>243</sup> Final rule 211(h)(1)-2(b)(2).

<sup>244</sup> Cf. CFA Comment Letter II (noting that proposed rule 211(h)(1)-2(b)(2) could be read to “not capture fees and expenses that have been accrued and not yet paid”).

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 is required to 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.

A number of commenters generally supported this requirement to report all fees and expenses paid by the private fund during the reporting period on the quarterly statements.<sup>245</sup> Some commenters suggested that this requirement would be too costly or that existing market practices make this requirement unnecessary.<sup>246</sup>

We have observed two general trends among private fund advisers that support the rule’s approach to adviser disclosure of fund fees and expenses. First, we have observed certain advisers shift certain expenses related to their advisory business to private fund clients.<sup>247</sup> For example, some advisers charge private fund clients for salaries and benefits related to personnel of the adviser. Such expenses have traditionally been paid by advisers with their management fee proceeds or other revenue streams but are increasingly being charged as separate fund expenses, in addition to the management fee, and the full nature and extent of these expenses may not be clearly disclosed and transparent to fund investors.<sup>248</sup> Second, expenses have risen

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<sup>245</sup> See, *e.g.*, OFT Comment Letter; Comment Letter of Meketa Investment Group (Mar. 21, 2022) (“Meketa Comment Letter”); Comment Letter of the Teacher Retirement System of Texas (Apr. 25, 2022) (“TRS Comment Letter”).

<sup>246</sup> See, *e.g.*, AIC Comment Letter I; Dechert Comment Letter; ATR Comment Letter.

<sup>247</sup> See *supra* footnote 219 and accompanying text.

<sup>248</sup> See Key Findings ILPA Industry Intelligence Report, “What is Market in Fund Terms?” (2021), at 18-19 (“ILPA Key Findings Report”), available at <https://ilpa.org/wp-content/uploads/2021/10/Key-Findings-Industry-Intelligence-Report-Fund-Terms.pdf> (stating that “the importance of elevated transparency for [private fund investors] related to fees and expenses” is underscored by the recent trend of “cost shifting” certain expenses traditionally borne by private fund advisers to their private fund clients).

significantly in recent years for certain private funds due to, among other things, advisers' use of increasingly complex fund structures, the expansion of global marketing and investment efforts by advisers, and increased service provider costs.<sup>249</sup> Advisers often pass on such increases to the private funds they advise without providing investors detailed disclosure about the magnitude and type of expenses actually charged to, or directly or indirectly borne by, the fund. Without this information, however, investors are less able to effectively assess and monitor the costs of investing in private funds managed by an adviser.

Some commenters stated that we should allow advisers to group smaller expenses generally into broad categories or disclose them as "miscellaneous" expenses.<sup>250</sup> Other commenters requested that we allow exemptions for *de minimis* amounts in the fee and expense section of the quarterly statement.<sup>251</sup> In contrast, one commenter suggested that we specifically not permit advisers to exclude *de minimis* expenses or group small expenses into broad categories.<sup>252</sup> We are not allowing advisers to exclude *de minimis* expenses, generally group small expenses into broad categories, or label expenses as miscellaneous. Private fund investors need detailed accounting of fees and expenses to understand fully the costs of their private fund investments. If we were to allow advisers to group small expenses generally into broad categories, they might be able to obscure certain costs from investors, including those that could raise conflict of interest issues. Similarly, advisers might use a *de minimis* exception to avoid disclosing individual expenses that, in aggregate, could be significant. These alternative

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<sup>249</sup> See, e.g., *id.*; see also Coming to Terms: Private Equity Investors Face Rising Costs, Extra Fees, Wall Street Journal (Dec. 20, 2021), available at <https://www.wsj.com/articles/coming-to-terms-private-equity-investors-face-rising-costs-extra-fees-11640001604>.

<sup>250</sup> See, e.g., AIC Comment Letter II; Comment Letter of CFA Institute (Apr. 25, 2022) ("CFA Comment Letter I"); IAA Comment Letter II.

<sup>251</sup> See, e.g., AIC Comment Letter I; PIFF Comment Letter; Ropes & Gray Comment Letter.

<sup>252</sup> See Convergence Comment Letter.

approaches would not provide private fund investors with sufficient detail to assess and monitor whether that the private fund expenses borne by the fund conform to contractual agreements and the private fund's terms.

As discussed above,<sup>253</sup> some commenters suggested that section 211(h)(1) of the Act, which states that the Commission shall facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment advisers, does not authorize the rule's quarterly disclosure requirement with respect to fund fees and expenses. These commenters generally asserted that ongoing fund fee and expense reporting does not constitute disclosure of the terms of the relationship between private fund investors and private fund advisers for purposes of section 211(h)(1) of the Act and that such terms are instead disclosed only at the outset of the relationship between a private fund investor and a private fund adviser; namely, in the terms set forth in a private fund's contractual documents.<sup>254</sup> Although we recognize that the methodology for calculating fund fees and expenses is typically set forth in a fund's contractual documents, as discussed above, investors must also receive simple and clear disclosures of the actual fees and expenses borne by their fund in order to be able to understand and confirm effectively the accuracy of the terms of their relationship with a private fund adviser.

To the extent that a fund expense also could be characterized as adviser compensation under the rule, the rule requires advisers to disclose such payment or allocation as adviser compensation as opposed to a fund expense in the quarterly statement. For example, certain private funds may engage the adviser or its related persons to provide non-advisory services to

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<sup>253</sup> See *supra* footnotes 166-169 and accompanying text.

<sup>254</sup> See, e.g., AIC Comment Letter I; NVCA Comment Letter; Citadel Comment Letter.

the fund, such as consulting, legal, or back-office services. The rule requires advisers to disclose any compensation, fees, or other amounts allocated or paid by the fund for such services, whether advisory or non-advisory, as part of the detailed accounting of adviser compensation. This approach will help ensure that investors understand the entire amount of adviser compensation allocated or paid to the adviser and its related persons during the reporting period by the fund.

*Offsets, Rebates, and Waivers.* We are requiring advisers to disclose adviser compensation and fund expenses in the fund table both before and after the application of any offsets, rebates, or waivers.<sup>255</sup> Specifically, the rule requires an adviser to present the dollar amount of each category of adviser compensation or fund expense<sup>256</sup> before and after any such reduction for the reporting period.<sup>257</sup> In addition, the rule requires advisers to disclose the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future adviser compensation.<sup>258</sup> We are adopting this portion of the rule as proposed.

Advisers may offset, rebate, or waive adviser compensation or fund expenses in a number of circumstances. For example, a private equity adviser may enter into a management services agreement with a fund's portfolio company, requiring the company to pay the adviser a fee for those services. To the extent that the fund's governing agreement requires the adviser to share

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<sup>255</sup> Final rule 211(h)(1)-2(b).

<sup>256</sup> For example, an adviser must show any placement agent fees or excess organizational expenses before and after any management fee offset.

<sup>257</sup> Offsets, rebates, and waivers applicable to certain, but not all, investors through one or more separate arrangements are required to be reflected and described prominently in the fund-wide numbers presented in the quarterly statement. See final rule 211(h)(1)-2(d) and (g). Advisers are not required to disclose the identity of the subset of investors that receive such offsets, rebates, or waivers.

<sup>258</sup> Final rule 211(h)(1)-2(b)(3).

the fee with the fund investors through an offset to the management fee, the management fee would typically be reduced, on a dollar-for-dollar basis, by an amount equal to the fee.<sup>259</sup> Under the final rule, the adviser would be required to list the management fee both before and after the application of the fee offset.

Some commenters generally supported the requirement that advisers disclose adviser compensation and fund expenses both before and after the application of any offsets, rebates, or waivers.<sup>260</sup> Some commenters suggested that advisers should only be required to disclose adviser compensation and fund expenses after the application of any offsets, rebates, or waivers, because information regarding adviser compensation and fund expenses before the application of any offsets, rebates, or waivers does not reflect actual investor experience and accordingly could confuse or be of little or no value to investors.<sup>261</sup> One commenter stated that we should consider excepting *de minimis* offsets, rebates, or waivers from this requirement.<sup>262</sup>

We considered whether to require advisers to disclose adviser compensation and fund expenses only after the application of offsets, rebates, and waivers, rather than before and after. We recognize that investors may find the reduced numbers more meaningful, given that they generally reflect the actual amounts borne by the fund during the reporting period. However, after considering comments, we believe that presenting both figures will provide investors with greater transparency into advisers' fee and expense practices, particularly with respect to how offsets, rebates, and waivers affect adviser compensation. Transparency into fee and expense

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<sup>259</sup> The offset shifts some or all of the economic benefit of the fee from the adviser to the private fund investors.

<sup>260</sup> See, e.g., Morningstar Comment Letter; CFA Comment Letter II; RFG Comment Letter II.

<sup>261</sup> See, e.g., IAA Comment Letter II; PIFF Comment Letter.

<sup>262</sup> See Ropes & Gray Comment Letter.



practices is important, even with respect to *de minimis* amounts, because it will assist investors in monitoring their private fund investments and, for certain investors, will ease their own efforts at complying with their reporting obligations.<sup>263</sup> Advisers should have this information readily available, and both sets of figures will be helpful to investors in monitoring whether and how offsets, rebates, and waivers are applied.

In addition, we are requiring advisers to disclose the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future adviser compensation.<sup>264</sup> This information will allow investors to understand whether they are or the fund is entitled to additional reductions in future periods.<sup>265</sup> Further, this information will assist investors with their liquidity management and cash flow models, as they should have greater insight into the fund's projected cash flows and their obligations to satisfy future capital calls for adviser compensation with cash on hand.

#### **b) Portfolio Investment-Level Disclosure**

The quarterly statement rule requires advisers to disclose a detailed accounting of all portfolio investment compensation<sup>266</sup> allocated or paid by each covered portfolio investment<sup>267</sup>

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<sup>263</sup> For example, certain investors, such as U.S. State pension plans, may be required to report complete information regarding fees and expenses paid to the adviser and its related persons. *See* LACERA Comment Letter.

<sup>264</sup> Final rule 211(h)(1)-2(b)(3).

<sup>265</sup> To the extent advisers are required to offset fund-level compensation (*e.g.*, management fees) by portfolio investment compensation (*e.g.*, monitoring fees), they typically do not reduce adviser compensation below zero, meaning that, in the event the monitoring fee offset amount exceeds the management fee for the applicable period, some fund documents provide for “carryforwards” of the unused amount. The carryforwards are used to offset the management fee in subsequent periods.

<sup>266</sup> *See* final rule 211(h)(1)-1 (defining “portfolio investment compensation” as any compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the portfolio investment attributable to the private fund’s interest in such portfolio investment).

<sup>267</sup> *See* final rule 211(h)(1)-1 (defining “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).

during the reporting period in a single table. We proposed, but in response to commenters are not adopting, a requirement that advisers disclose the private fund’s ownership percentage of each covered portfolio investment. We discuss each of these aspects of the final rule below.

The rule defines “portfolio investment” as any entity or issuer in which the private fund has invested directly or indirectly, as proposed.<sup>268</sup> This definition is designed to capture any entity or issuer in which the private fund holds an investment, including through holding companies, subsidiaries, acquisition vehicles, special purpose vehicles, and other vehicles through which investments are made or otherwise held by the private fund.<sup>269</sup> As a result, the definition may capture more than one entity or issuer with respect to any single investment made by a private fund. For example, if a private fund invests directly in a holding company that owns two subsidiaries, this definition captures all three entities.

One commenter supported the proposed definition of “portfolio investment.”<sup>270</sup> Other commenters proposed alternative definitions, such as to broaden the definition to cover broken deal expenses<sup>271</sup> or to narrow the definition to refer only to an issuer of securities in which the

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<sup>268</sup> Final rule 211(h)(1)-1.

<sup>269</sup> Certain investment strategies can involve complex transactions and the use of negotiated instruments or contracts, such as derivatives, with counterparties. Although such trading involves a risk that a counterparty will not settle a transaction or otherwise fail to perform its obligations under the instrument or contract and thus result in losses to the fund, we would generally not consider the fund to have made an investment in the counterparty in this context. This approach is appropriate because any gain or loss from the investment generally would be tied to the performance of the derivative and the underlying reference security, rather than the performance of the counterparty.

<sup>270</sup> See Convergence Comment Letter.

<sup>271</sup> See CFA Comment Letter II (observing that the proposed definition would not cover broken deal expenses). We understand that broken deal fees are often associated with situations in which ownership of a potential portfolio investment is in flux. 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

private fund has *directly* invested.<sup>272</sup> One commenter suggested limiting the definition of “covered portfolio investment” to portfolio investments over which the adviser has “discretion or substantial influence” to compensate the adviser or its related persons.<sup>273</sup>

Many commenters discussed how the proposed definitions of “portfolio investment” and “covered portfolio investment” would impact advisers to funds of funds. Some commenters suggested that we exclude from these definitions funds of funds and other pooled vehicles that invest indirectly through underlying funds or unaffiliated structures.<sup>274</sup> In contrast, another commenter stated that we should not exempt funds of funds because advisers to funds of funds should be able to provide the required information.<sup>275</sup> Despite commenter concerns, we are adopting these definitions as proposed in order to capture, and improve investor transparency into, portfolio investment compensation arrangements that pose potential or actual conflicts of interest for the adviser, without exception for advisers of fund of funds. 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 under the final rule. For example, the fund of funds adviser 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. However, we recognize that, despite

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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. Because this information will thus be reported as a fund fee or expense under the rule whenever a fund’s assets are actually reduced by broken deal expenses, we believe it is unnecessary to also require disclosure of this information as a type of portfolio investment compensation through changes to the definition of “portfolio investment” under the rule.

<sup>272</sup> See AIMA/ACC Comment Letter.

<sup>273</sup> See PIFF Comment Letter; *cf. infra* footnote 287.

<sup>274</sup> See AIC Comment Letter I; PIFF Comment Letter.

<sup>275</sup> See Convergence Comment Letter.

their best efforts, certain fund of funds advisers may lack information or may not be given information in respect of underlying entities, and depending on a private fund's underlying investment structure, a fund of funds adviser may have to rely on good faith belief to determine which entity or entities constitute a portfolio investment under the rule. An adviser may consider documenting this determination, as well as its initial and ongoing diligence efforts to determine whether a portfolio investment has compensated the adviser or its related persons, in its records.

We recognize that portfolio investments of certain private funds may not pay or allocate portfolio investment compensation to an adviser or its related persons. For example, advisers to hedge funds focusing on passive investments in public companies may be less likely to receive portfolio investment compensation than advisers to private equity funds focusing on control-oriented investments in private companies. Under the final rule, advisers are required to disclose information regarding only *covered portfolio investments*, which are defined as portfolio investments that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period, as proposed.<sup>276</sup> We believe this approach is appropriate because the portfolio investment table is designed to highlight the scope and magnitude of any investment-level compensation and to improve transparency for investors into the potential and actual conflicts of interest of the adviser and its related persons. If an adviser or its related person does not receive investment-level compensation under the final definition of *covered portfolio investment*, the adviser will not have a related disclosure obligation under the rule. Accordingly, the rule does not require advisers to list any information regarding portfolio investments that do not fall within the *covered portfolio investment* definition for the applicable reporting period. These advisers, however, need to identify portfolio investment payments and

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<sup>276</sup> See final rule 211(h)(1)-1 (defining “covered portfolio investment”).

allocations in order to determine whether they must provide the disclosures under this requirement.

*Portfolio Investment Compensation.* The rule requires the portfolio investment table to show a detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, 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. An adviser 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.

Similar to the approach taken with respect to adviser compensation and fund expenses discussed above, the rule requires a detailed accounting of *all* portfolio investment compensation paid or allocated to the adviser and its related persons.<sup>277</sup> This will require advisers to list as a separate line item each category of portfolio investment compensation<sup>278</sup> and the corresponding total dollar amount.

The rule requires advisers to disclose the amount of portfolio investment compensation attributable to a private fund's interest in a covered portfolio investment.<sup>279</sup> Such amount should not reflect the portion attributable to any other person's interest in the covered portfolio

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<sup>277</sup> Because advisers often use separate legal entities to conduct a single advisory business, the rule will capture portfolio investment compensation paid to an adviser's related persons.

<sup>278</sup> This includes cash or non-cash compensation, including, for example, stock, options, and warrants.

<sup>279</sup> See final rule 211(h)(1)-1 (defining "portfolio investment compensation").

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. In addition to the required disclosure under the rule relating to the fund's interest in the portfolio investment, advisers may, but are not required to, list the portion of the fee attributable to any other person's interest in the portfolio investment. This approach is appropriate because it will reflect the amount borne by the fund and, by extension, the investors. This will be meaningful information for investors because the amount attributable to the fund's interest generally reduces the value of investors' indirect interest in the portfolio investment.<sup>280</sup>

Similar to the approach discussed above with respect to adviser compensation and fund expenses, an adviser is required to list the amount of portfolio investment compensation allocated or paid with respect to each covered portfolio investment both *before and after the application of any offsets, rebates, or waivers*. This will require an adviser to present the aggregate dollar amount attributable to the fund's interest before and after any such reduction for the reporting period. Advisers will be required to disclose the amount of any portfolio investment compensation that they initially charge and the amount that they ultimately retain at the expense of the private fund and its investors.

We continue to believe that this approach is appropriate given that portfolio investment compensation can take many different forms and often varies based on fund type. For example,

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<sup>280</sup> This information should be meaningful for investors regardless of whether the private fund has an equity ownership interest or another kind of interest in the covered portfolio investment. For example, if a private fund's interest in a covered portfolio investment is represented by a debt instrument, the amount of portfolio-investment compensation paid or allocated to the adviser may hinder or prevent the covered portfolio investment from satisfying its obligations to the fund under the debt instrument.

portfolio investments of private credit funds may pay the adviser a servicing fee for managing a pool of loans held directly or indirectly by the fund. Portfolio investments of private real estate funds may pay the adviser a property management fee or a mortgage-servicing fee for managing the real estate investments held directly or indirectly by the fund.

This disclosure will help inform investors about the scope of portfolio investment compensation allocated or paid to the adviser and related persons and provide insight to investors into the nature of some of the potential or actual conflicts of interest their private fund advisers face. For example, in cases where an adviser controls a fund’s portfolio investment, the adviser also generally has discretion over whether to charge portfolio investment compensation and, if so, the rate, timing, method, amount, and recipient of such compensation. Additionally, where the private fund’s governing documents require the adviser to offset portfolio investment compensation against other revenue streams or otherwise provide a rebate to investors, this information will help investors monitor the application of such offsets or rebates.

As with adviser compensation and fund expenses, this approach should provide investors with sufficient detail to validate that portfolio investment compensation borne by the fund conforms to contractual agreements.

Some commenters supported this portfolio investment compensation reporting requirement, stating that it will increase transparency.<sup>281</sup> Other commenters suggested that this requirement will be overly burdensome or unnecessary.<sup>282</sup> Some commenters similarly suggested that this portfolio investment compensation disclosure requirement will be overly

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<sup>281</sup> See, e.g., OFT Comment Letter; LACERA Comment Letter; XTP Comment Letter.

<sup>282</sup> See, e.g., AIC Comment Letter I; Comment Letter of the Goldman Sachs Group, Inc. (Apr. 25, 2022) (“Goldman Comment Letter”); IAA Comment Letter II.

broad in its application, as described below.<sup>283</sup> One commenter stated that each private fund is itself a “related person” of the adviser, so any amounts paid to a fund (*e.g.*, dividends on equity investments or interest and fees on debt investments) would be reportable under the rule as drafted, even though the fund’s investors receive 100% of the benefit.<sup>284</sup> Another commenter requested that we clarify that the definition of “portfolio investment compensation” excludes fund-level fees and other compensation paid by a subsidiary of the fund in accordance with the fund’s governing documents.<sup>285</sup>

To clarify, this portfolio investment compensation disclosure requirement does not include distributions representing profit or return of capital to the fund, in each case, in respect of the fund’s ownership or other interest in a portfolio investment (*e.g.*, dividends). This disclosure requirement is intended generally to capture potentially or actually conflicted compensation arrangements where the fund’s interest in a portfolio investment may be negatively impacted by that portfolio investment’s allocation or payment of portfolio investment compensation to the fund’s adviser or its related persons, such as when an adviser or its related person charges a monitoring fee to a portfolio investment of a fund it advises, including when such charges are made in accordance with the fund’s governing documents. Although investors may contractually agree, per a fund’s governing documents and with appropriate initial disclosure, to an adviser’s ability to receive portfolio investment compensation, investors may be misled with respect to the

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<sup>283</sup> See, *e.g.*, MFA Comment Letter I; PIFF Comment Letter.

<sup>284</sup> See MFA Comment Letter I.

<sup>285</sup> See PIFF Comment Letter. This commenter also suggested that including adviser compensation paid by a subsidiary of the fund as portfolio investment compensation will result in duplicate disclosure of these compensation amounts. To the extent that a subsidiary of the fund compensates the investment adviser on behalf of the fund, whether such compensation amounts should be disclosed in the fund table or the portfolio-investment table will depend on the facts and circumstances and, in particular, whether the subsidiary is an entity or issuer in which the fund has invested (*i.e.*, a portfolio investment). However, such compensation amounts would not need to be disclosed twice (unless the adviser discloses such compensation amounts before and after the application of any offsets, rebates, or waivers, if applicable).



magnitude and scope of such compensation to the extent that an adviser does not disclose information relating to the total dollar amount of such compensation after the fact.

The rule requires an adviser to include the portfolio investment compensation paid to a related person, including, without limitation, a related person that is a sub-adviser, in its quarterly statement. Because portfolio investment compensation to related sub-advisers presents the same conflicts of interest concerns discussed above with respect to portfolio investment compensation to advisers, the portfolio investment compensation disclosure requirements under the rule extends to portfolio investment compensation to an adviser or any of its related persons, including a related sub-adviser, as proposed.

Some commenters stated that we should require only aggregate portfolio investment-level disclosure and not each instance of portfolio investment compensation in order to provide more helpful information to investors, reduce costs and compliance burdens for advisers, or to avoid potentially causing portfolio companies to decline private fund investments.<sup>286</sup> Although we recognize that it could be simpler or less burdensome for certain advisers to provide aggregate information, it is important that investors are made aware of each instance of portfolio investment compensation to the adviser. Investors should be able to analyze each such instance and raise any potential concerns about these compensation schemes with the adviser. Aggregated information could provide investors with a sense of the magnitude of such compensation schemes, but investors may not be able to understand the nature and scope of the conflicts associated with portfolio investment compensation to the adviser.

Several commenters stated that the requirement to disclose portfolio investment compensation should be limited to circumstances in which an adviser has the discretion or

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<sup>286</sup> See, e.g., PIFF Comment Letter; CFA Comment Letter I; Goldman Comment Letter.

authority to cause a portfolio investment to compensate the adviser or its related persons, as those are the circumstances in which conflicts of interest would arise.<sup>287</sup> In contrast, another commenter supported our proposed approach and stated that advisers should be required to report portfolio investment compensation regardless of whether they have such discretion or authority over a portfolio investment.<sup>288</sup> Other commenters suggested that the portfolio investment compensation disclosure requirement should exclude portfolio investment compensation to an adviser's related persons that are operationally and otherwise independent of the adviser, stating that some advisers have related persons who negotiate with advisers or their affiliates on an arm's-length basis and would not represent their interests when negotiating with a portfolio investment.<sup>289</sup> Although we understand that conflicts of interest issues are heightened when an adviser has the discretion or authority to control a portfolio investment (and in the context of portfolio investment compensation to a related person, to control such related person), we recognize that potential or actual conflicts of interest are not limited to scenarios where an adviser has such control and may arise, for instance, where an adviser does not have control but has substantial influence over a portfolio investment (or in the context of portfolio investment compensation to a related person, over such related person) and the portfolio investment is compensating the adviser or its related persons.<sup>290</sup> As a result, we believe that it is necessary to

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<sup>287</sup> See, e.g., AIMA/ACC Comment Letter; SIFMA-AMG Comment Letter I; SBAI Comment Letter; *see also supra* footnote 273.

<sup>288</sup> See Convergence Comment Letter.

<sup>289</sup> See, e.g., AIC Comment Letter I; Goldman Comment Letter.

<sup>290</sup> An adviser may be subject to a potential or actual conflict of interest arising out of its substantial influence over a portfolio investment, for example, if a fund it advises owns a sizeable but non-controlling share of the investment or if the portfolio investment is otherwise dependent on the adviser to operate its business. More broadly, we have recognized that an adviser is generally subject to a potential or actual conflict of interest with an advisory client when it has a conflicting interest that "might incline [the] investment adviser—consciously or unconsciously—to render advice which was not disinterested." IA Fiduciary Duty Release, *supra* footnote 58, at 23.

provide investors with comprehensive information regarding payments of portfolio investment compensation allocated or paid to an adviser or its related person, without limitation to circumstances in which an adviser has discretion or authority over the portfolio investment (or over the related person, as applicable).

Some commenters raised concerns about potential confidentiality issues if advisers are required to disclose the names of portfolio investments as part of this portfolio investment compensation disclosure.<sup>291</sup> Although we appreciate these confidentiality concerns, we believe that many investors may likely already know the names of the fund’s portfolio investments. Even if investors do not know this information, investors are typically subject to contractual obligations to maintain the confidentiality of this information. Further, as stated above, 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, advisers may use consistent code names (e.g., “portfolio investment A”).

*Ownership Percentage.* We proposed but are not adopting a requirement that the portfolio investment table include a list of the fund’s ownership percentage of each covered portfolio investment. At proposal, we stated that we believed this information would provide investors with helpful context for the amount of portfolio investment compensation paid or allocated to the adviser or its related persons relative to the fund’s ownership. For example, if portfolio investment compensation is calculated based on the portfolio investment’s total

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<sup>291</sup> See, e.g., PIFF Comment Letter; AIMA/ACC Comment Letter.

enterprise value, then investors would be able to compare the amount of portfolio investment compensation relative to the fund's ownership percentage.

One commenter indicated that these ownership percentages would not be helpful for investors in practice.<sup>292</sup> Another commenter stated that calculating and recording ownership percentages of portfolio investments would be onerous and costly.<sup>293</sup> Another commenter suggested that we should require advisers to disclose these ownership percentages only if the adviser has discretion or substantial influence to cause the accompanying portfolio investment compensation to be paid to the adviser.<sup>294</sup> In contrast, one commenter suggested expanding the ownership percentage disclosure obligation to cover any economic right, interest, or benefit that the fund has in a company.<sup>295</sup> Although we maintain that these ownership percentages might provide illustrative information for investors in certain circumstances, like the one noted above, we recognize that they might be misleading or unhelpful in other cases. For instance, if a fund owns voting stock in a company with a significant amount of non-voting stock, then the ownership percentage might appear low relative to the amount of control that the fund's adviser actually exerts. Similarly, if a fund owns only a debt interest in a portfolio investment, its ownership percentage would be represented as zero even if the debt interest is substantial enough that the fund's adviser can exact some sort of compensation for itself. We do not want investors to misestimate the degree to which advisers are able to influence portfolio investments to provide compensation. Accordingly, in response to commenters, we have decided not to adopt this requirement to include ownership percentages for covered portfolio investments.

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<sup>292</sup> See CFA Comment Letter I.

<sup>293</sup> See ATR Comment Letter.

<sup>294</sup> See PIFF Comment Letter.

<sup>295</sup> See Convergence Comment Letter.

**c)      Calculations and Cross-References to Organizational and  
Offering Documents**

As proposed, the quarterly statement rule requires each statement to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated.<sup>296</sup> This disclosure should assist private fund investors in understanding and evaluating the adviser’s calculations. This disclosure will generally require advisers to describe, among other things, the structure of, and the method used to determine, any performance-based compensation set forth in the quarterly statement (such as the distribution waterfall, if applicable) and the criteria on which each type of compensation is based (*e.g.*, whether such compensation is fixed, based on performance over a certain period, or based on the value of the fund’s assets). To facilitate an investor’s ability to seek additional information and understand the basis of any expense, payment, allocation, rebate, waiver, or offset calculation, the quarterly statement also must include cross-references to the relevant sections of the private fund’s organizational and offering documents that set forth the applicable calculation methodology.<sup>297</sup>

Some commenters supported this calculation and cross-reference disclosure requirement, stating that it would help investors monitor and understand fees and expenses.<sup>298</sup> Other commenters suggested that this calculation and cross-reference disclosure requirement would be

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<sup>296</sup> Final rule 211(h)(1)-2(d).

<sup>297</sup> *Id.*

<sup>298</sup> *See, e.g.*, Comment Letter of Albourne Group (Apr. 22, 2022) (“Albourne Comment Letter”); TRS Comment Letter; Comment Letter of the California Public Employees’ Retirement System (May 3, 2022) (“CalPERS Comment Letter”).

too costly or that it would clutter the statement and make it more difficult for investors to read and digest the information contained therein.<sup>299</sup>

The required cross-references to the fund's documents will enable investors to compare what the private fund's documents establish that the fund (and indirectly the investors) will be *obligated* to pay to what the fund (and indirectly the investors) *actually* paid during the reporting period and thus to assess and monitor more effectively the accuracy of the payments. Including this information in the quarterly statement will better enable an investor to confirm that the adviser calculated, for example, advisory fees in accordance with the fund's organizational and offering documents and to identify whether the adviser deducted or charged incorrect or unauthorized amounts.

## **2. Performance Disclosure**

As proposed, in addition to providing information regarding fees and expenses, the rule requires advisers to include standardized fund performance information in each quarterly statement provided to fund investors. The rule requires advisers to liquid funds<sup>300</sup> 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,<sup>301</sup> the rule requires advisers to show performance based on internal rates of return and multiples of invested capital since inception and to present a

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<sup>299</sup> See, e.g., LSTA Comment Letter; AIMA/ACC Comment Letter; IAA Comment Letter II.

<sup>300</sup> The definition of a liquid fund is discussed below in this section II.B.2.

<sup>301</sup> The definition of an illiquid fund is discussed below in this section II.B.2.

statement of contributions and distributions.<sup>302</sup> The rule requires advisers to display the different categories of required performance information with equal prominence.<sup>303</sup>

Many commenters supported the performance disclosure requirement and generally suggested that it would better enable investors to monitor, compare, or otherwise alter their private fund investments.<sup>304</sup> Other commenters did not support this requirement for a number of reasons.<sup>305</sup> In general, opponents of this requirement stated that the required performance disclosure in the quarterly statements would lead to increased costs that would ultimately be passed down to private fund investors with potentially little or no corresponding benefit, as many advisers already regularly provide performance reporting that they assert investors deem adequate.<sup>306</sup> These commenters stated that current market practices are typically sufficient and can potentially be more effective in conveying relevant and fund-tailored information regarding a private fund's performance than a standardized disclosure approach would.<sup>307</sup>

While we acknowledge that quarterly statements may increase costs, we believe these costs are justified in light of the benefits of the rule.<sup>308</sup> It is essential that quarterly statements

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<sup>302</sup> As discussed below, we are adopting modifications to (i) the proposed definition of illiquid fund and, by reference, the proposed definition of liquid fund and (ii) certain aspects of the required performance disclosure for illiquid funds.

<sup>303</sup> Final rule 211(h)(1)-2(e)(2). For example, the rule requires an adviser to an illiquid fund to show gross internal rate of return with the same prominence as net internal rate of return. Similarly, the rule requires an adviser to a liquid fund to show the annual net total return for each fiscal year with the same prominence as the cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.

<sup>304</sup> See, e.g., CII Comment Letter; NEA and AFT Comment Letter; OPERS Comment Letter; Morningstar Comment Letter.

<sup>305</sup> See, e.g., IAA Comment Letter II; Comment Letter of ApeVue, Inc. (Apr. 25, 2022); ICM Comment Letter.

<sup>306</sup> See, e.g., Ropes & Gray Comment Letter; NYC Bar Comment Letter II. While we acknowledge that quarterly statements may increase costs, we believe these costs are justified in light of the benefits of the rule. As discussed above, investors will benefit from mandatory timely updates regarding fund performance. See *supra* the introductory discussion in section II.B.

<sup>307</sup> See, e.g., Schulte Comment Letter; PIFF Comment Letter; NYC Bar Comment Letter II.

<sup>308</sup> See *infra* section VI.D.2.

include performance in order to enable investors to compare private fund investments, comprehensively understand their existing investments, and determine what to do holistically with their overall investment portfolio.<sup>309</sup> A quarterly statement that includes fee, expense, and performance information will allow investors to monitor their investments better for market developments and potential fund-level abnormalities (*e.g.*, if performance varies drastically quarter to quarter or differs extensively from relevant market trends or, if applicable, comparable benchmarks), as well as to understand more broadly the impact of fees and expenses on the performance of their investments. Simple and clear disclosure of this information is fundamental to the terms of an investor's relationship with an adviser because it is critical to investors' abilities to make investment decisions. For example, a quarterly statement that includes fee and expense, but not performance, information would not allow an investor to perform a cost-benefit analysis to determine whether to retain the current investment or consider other options. Similarly, an investor without fee, expense, and performance information would be unable to determine whether to invest in other private funds managed by the same adviser. In addition, investors may use fee, expense, and performance information about their current investments to inform their overall investment decisions (*e.g.*, whether to diversify) and their view of the market. The inclusion of performance disclosure in the quarterly statement also helps prevent fraud, deception, and manipulation because it requires advisers to provide timely and consistent performance disclosures to enable and empower investors to assess adviser performance. This disclosure will decrease the likelihood that investors will be defrauded, deceived, or manipulated

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<sup>309</sup> See *infra* section II.B.2.a) and section II.B.2.b) for discussion of the use of the particular performance metrics obligations for liquid funds and illiquid funds, respectively, in the final rule.



by deceptive or manipulative representations of performance and it increases the likelihood that any misconduct will be detected sooner.

One commenter stated that we should align the performance reporting standards with the principles-based approach reflected in the marketing rule.<sup>310</sup> Although there are commonalities between the performance reporting elements of the final rule and the performance elements of our recently adopted marketing rule, the two rules have different purposes that stem from the needs of the different types of clients and investors they seek to protect. While the marketing rule is focused on prospective clients and investors,<sup>311</sup> the quarterly statement rule is focused on current clients and investors. All clients and investors should be protected against misleading, deceptive, and confusing information, but current clients and investors have different needs from those of prospective clients and investors. Current investors should receive performance reporting that allows them to evaluate an investment alongside corresponding fee and expense information. Current investors also should receive performance reporting that is provided at timely, predictable intervals so that an investor can monitor and evaluate an investment's progress over time, remain abreast of changes, compare information from quarter to quarter, and take action where possible.<sup>312</sup> Although the marketing rule requires net performance to accompany gross performance, it does not prescribe a breakdown of fees and expenses to accompany performance as is required under the quarterly statement rule. The marketing rule

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<sup>310</sup> See AIMA/ACC Comment Letter.

<sup>311</sup> Advertisements to prospective clients and investors include advertisements to current clients and investors about new or additional advisory services with regard to securities. See Marketing Release, *supra* footnote 127, at section II.A.2.a.iv (noting that the definition of “advertisement” includes a communication to a current investor that offers new or additional advisory services with regard to securities, provided that the communication otherwise satisfies the definition of “advertisement”).

<sup>312</sup> The marketing rule and its specific protections generally do not apply in the context of a quarterly statement. See Marketing Release, *supra* footnote 127, at sections II.A.2.a.iv and II.A.4.

also does not require performance to be delivered at specified intervals as is required under the quarterly statement rule. While these rules both promote investor protection, the quarterly statement rule is specifically designed to meet the needs of current investors to evaluate their current portfolios.

Without standardized performance metrics (and adequate disclosure of the criteria used and assumptions made in calculating the performance),<sup>313</sup> it is more difficult for investors to compare their private fund investments managed by the same adviser or gauge the value of an adviser's investment management services by comparing the performance of private funds advised by different advisers.<sup>314</sup> Currently, there are various approaches to report private fund performance to fund investors, often depending on the type of private fund (*e.g.*, the fund's strategy, structure, target asset class, investment horizon, and liquidity profile). Certain of these approaches to performance reporting may be misleading without the benefit of adequately disclosed assumptions, and others may lead to investor confusion. For example, an adviser showing internal rate of return with the impact of fund-level subscription facilities could mislead investors as fund-level subscription facilities can artificially increase performance metrics.<sup>315</sup> An adviser showing private fund performance as compared to a public market equivalent ("PME") in a case where the private fund does not have an appropriate benchmark may mislead investors to believe that the private fund performance is comparable to the performance of the PME.

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<sup>313</sup> Private funds can have various types of complicated structures and involve complex financing mechanisms. As a result, an adviser may need to make certain assumptions when calculating performance for private funds.

<sup>314</sup> See David Snow, *Private Equity: A Brief Overview: An introduction to the fundamentals of an expanding, global industry*, PEI Media (2007), at 11 (discussing variations on private equity performance metrics).

<sup>315</sup> See *infra* section II.B.2.b).

Certain investors may also be led to believe that their private fund investment has a liquidity profile that is similar to an investment in the PME or an index that is similar to the PME.

Standardized performance information will help an investor decide whether to continue to invest in the private fund or, if applicable, redeem or withdraw from the private fund, as well as more holistically to make decisions about other components of the investor's portfolio. Furthermore, requiring advisers to show performance information alongside fee and expense information in the quarterly statement will provide a more complete picture of an investor's private fund investment. This information will help investors understand the true cost of investing in the private fund and be particularly valuable for investors that are paying performance-based compensation. This performance reporting will also provide greater transparency into how private fund performance is calculated, improving an investor's ability to understand performance.

One commenter requested that we clarify that investors may negotiate for performance and other reporting in addition to what is required by this rule.<sup>316</sup> The rule recognizes the need for different performance metrics for private funds based on certain fund characteristics, but also imposes a general framework to help ensure there is sufficient standardization in order to provide useful, comparable information to investors. An adviser remains free to include additional performance metrics in the quarterly statement as long as the quarterly statement presents the performance metrics prescribed by the rule and complies with the other requirements in the rule. However, advisers that choose to include additional information should consider what other rules and regulations might apply. For example, although we generally do not consider information in the quarterly statement required by the rule to be an "advertisement" under the marketing rule, an

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<sup>316</sup> See NYC Comptroller Comment Letter.

adviser that offers new or additional investment advisory services with regard to securities in the quarterly statement would need to consider whether such information is subject to the marketing rule.<sup>317</sup> An adviser also needs to consider whether performance information presented outside of the required quarterly statement, even if it contains some of the same information as the quarterly statement, is subject to, and meets the requirements of, the marketing rule. Regardless, the quarterly statement is subject to the antifraud provisions of the Federal securities laws.<sup>318</sup>

Some commenters suggested that we should also require a public market equivalent (“PME”) as part of the quarterly statements.<sup>319</sup> While a PME may be helpful in certain circumstances, it can also be misleading or confusing in others. Many private fund investment strategies may not have an appropriate PME. For example, it may be difficult to identify an effective PME for a private fund whose strategy is focused on turn-around opportunities for private companies. Similarly, it may be challenging to identify appropriate PMEs for certain private funds with highly technical or niche strategies. A PME may also mislead investors to believe that their investment has a similar liquidity profile to the PME. For example, comparing the performance of a technology-focused buy-out fund to a public technology company index may obscure the reality that the former is illiquid while the latter is liquid and thus a reasonable investor would not necessarily expect them to have the same performance. Accordingly, the final rule does not require a PME as part of the quarterly statements.

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<sup>317</sup> See rule 206(4)-1. A communication to a current investor is an “advertisement” when it offers new or additional investment advisory services with regard to securities.

<sup>318</sup> This includes the antifraud provisions of section 206 of the Advisers Act, rule 206(4)-8 under the Advisers Act (rule 206(4)-8), section 17(a) of the Securities Act, and section 10(b) of the Exchange Act (and rule 10b-5 thereunder), to the extent relevant.

<sup>319</sup> See, e.g., NEA and AFT Comment Letter; Comment Letter of the Interfaith Center on Corporate Responsibility (Apr. 25, 2022) (“ICCR Comment Letter”); AFL-CIO Comment Letter.

Certain commenters suggested that we should clarify that the adviser's (and its affiliate's) interests should be excluded when calculating performance because such interests are typically non-fee paying.<sup>320</sup> We agree that the adviser's (and its affiliate's) interests should generally be excluded when calculating performance for the quarterly statements to prevent the performance from being misleading. A typical example would be the general partner's interest in a private fund, which generally does not pay management fees or carried interest. Due to the lack of fees, the performance of such non-fee paying interests is not necessarily relevant for other investors and would serve to increase net returns in a way that could be misleading.

One commenter suggested that we should not require performance metrics until the fund has at least four quarters of results.<sup>321</sup> While some private funds may have limited investment activities during the first four quarters of their life, it is not always such the case. Many liquid funds are able to deploy capital quickly and, as a result, generate important performance information that investors should have access to. Because investors have the ability to redeem from liquid funds, it is also important that they begin receiving performance information as soon as practicable so that they can decide whether or not to remain invested in the fund. Many illiquid funds are also able to deploy capital and realize or partially realize investments on an accelerated basis and thus will have meaningful performance information in the early quarters of their life. Accordingly, we are requiring all private funds, whether liquid or illiquid, to provide quarterly statements containing these performance metrics after their first two full fiscal quarters of operating results.

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<sup>320</sup> See CFA Comment Letter I; Comment Letter of KPMG LLP (Apr. 25, 2022) ("KPMG Comment Letter").

<sup>321</sup> See AIC Comment Letter II.

### *Liquid v. Illiquid Fund Determination*

The performance disclosure requirements of the quarterly statement rule require an adviser 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.<sup>322</sup> The adviser is then required to present certain performance information depending on this categorization. These definitions are intended to facilitate consistent portrayals of the fund returns over time as well as more standardized comparisons of the performance of similar funds.

We are defining “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.<sup>323</sup>

At proposal, we had listed six factors used to identify an illiquid fund: a private fund that (i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor’s request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments. The proposed factors were aligned with the factors for determining how certain types of private funds should report performance under U.S. Generally Accepted Accounting

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<sup>322</sup> Final rule 211(h)(1)-2(e)(1). The rule does not require the adviser to revisit the determination periodically; however, advisers should generally consider whether they are providing accurate information to investors and whether they need to revisit the liquid/illiquid determination based on changes in the fund.

<sup>323</sup> Final rule 211(h)(1)-1 (defining “illiquid fund”).

Principles (“U.S. GAAP”).<sup>324</sup> We requested comment on whether we should modify the illiquid fund definition by adding or removing factors.

Many commenters supported the liquid and illiquid fund distinction as part of the required performance reporting,<sup>325</sup> and many other commenters criticized it.<sup>326</sup> Of these, a number of commenters suggested we modify the proposed definitions for liquid and illiquid funds.<sup>327</sup> Certain commenters stated that the distinction between liquid and illiquid funds is overly technical and does not align with how sponsors typically market their private funds, particularly with respect to the proposed “disposition of investments” prong.<sup>328</sup> We had requested comment specifically regarding whether the proposed “disposition of investments” prong could cause certain funds, such as real estate funds and credit funds, for which we generally believe internal rate of return and multiple of invested capital are the appropriate performance measures, to be treated as liquid funds under the proposed rule.<sup>329</sup> Certain commenters responded with their view that the proposed rule would result in private funds that should report an internal rate of return and multiple of invested capital instead reporting a total net return metric (or *vice versa*).<sup>330</sup> Similarly, a commenter stated that we should define “illiquid fund” more precisely to capture strategies such as private credit, *e.g.*, income generating portion of assets, not just a focus on return of proceeds from the disposition of investments, as

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<sup>324</sup> See Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 946-205-50-23.

<sup>325</sup> See, *e.g.*, OFT Comment Letter; IST Comment Letter; CII Comment Letter.

<sup>326</sup> See, *e.g.*, Morningstar Comment Letter; SIFMA-AMG Comment Letter I; SBAI Comment Letter.

<sup>327</sup> See, *e.g.*, ILPA Comment Letter I; SIFMA-AMG Comment Letter I.

<sup>328</sup> Proposed prong (iv) states “...has as a predominant operating strategy the return of the proceeds from disposition of investments to investors.”

<sup>329</sup> See Proposing Release, *supra* footnote 3, at 62.

<sup>330</sup> See, *e.g.*, PIFF Comment Letter; Comment Letter of Pricewaterhouse Coopers LLP (Apr. 25, 2022) (“PWC Comment Letter”).

contemplated by prong four of the proposed definition.<sup>331</sup> Some commenters stated that it may be unclear how certain kinds of private funds would be categorized under the proposed six factor definition.<sup>332</sup>

After considering responses from commenters, we have decided that the definition of an illiquid fund should focus only on number three and number five of the proposed six factors, *i.e.*, 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 because we believe that redemption and withdrawal capability represents the distinguishing feature between illiquid and liquid funds. We also believe that, by narrowing the definition to this distinguishing feature, the rule provides a more targeted approach and will result in fewer funds being mischaracterized than under the proposed definition.

Generally, if a private fund allows voluntary redemptions/withdrawals, then it is a liquid fund and must provide total returns. Similarly, if a private fund does not allow voluntary redemptions/withdrawals, then it is an illiquid fund and must provide internal rates of return and multiples of invested capital. Private funds that fall into the "illiquid fund" definition are generally closed-end funds that do not offer periodic redemption/withdrawal options other than in exceptional circumstances, such as in response to regulatory events. For example, most private equity and venture capital funds will likely fall under the illiquid fund definition, and the rule requires advisers to these types of funds to provide performance metrics that suit their particular characteristics, such as irregular cash flows, which otherwise make measuring performance difficult for both advisers and investors. We recognize, however, that even

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<sup>331</sup> See ILPA Comment Letter I.

<sup>332</sup> See, *e.g.*, SIFMA-AMG Comment Letter I; Morningstar Comment Letter; Convergence Comment Letter.



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). Private equity and other similar closed-end funds would still be classified as illiquid funds, as defined in this rule, so long as such opportunities to redeem are limited.

As proposed, we are defining a “liquid fund” as any private fund that is not an illiquid fund. Some commenters generally supported the liquid and illiquid fund distinction as noted above,<sup>333</sup> while other commenters generally criticized the distinction.<sup>334</sup> We continue to believe that the proposed definition is appropriate because it will capture any fund that does not fit within the definition of “illiquid fund” and ensure that liquid fund investors receive the same type of performance metrics. Private funds that fall into the “liquid fund” definition generally allow periodic investor redemptions, such as monthly, quarterly, or semi-annually. The rule will require advisers to these types of funds to provide performance metrics that show the year-over-year return using the market value of the underlying assets.

We continue to believe that the performance metrics for liquid funds—which are discussed in detail below—will allow investors to assess better these funds’ performance. We understand that liquid funds generally are able to determine their net asset value on a regular basis and compute the year-over-year return using the market-based value of the underlying assets. We have taken a similar approach with regard to registered funds, which invest a substantial amount of their assets in primarily liquid holdings (*e.g.*, publicly traded securities)

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<sup>333</sup> See, *e.g.*, OFT Comment Letter; IST Comment Letter; CII Comment Letter.

<sup>334</sup> See, *e.g.*, Morningstar Comment Letter; SIFMA-AMG Comment Letter I; SBAI Comment Letter.

and, as a result, are also generally able to determine their net asset value on a regular basis and compute the year-over-year return using the market-based value of the underlying assets.

Investors in a private fund that is a liquid fund would similarly find this information helpful.

Most traditional hedge funds likely fall into the liquid bucket and will need to provide disclosures regarding the underlying assumptions of the performance (*e.g.*, whether dividends or other distributions are reinvested).

Some commenters suggested creating a third category to capture certain “hybrid” funds.<sup>335</sup> A third category for hybrid funds would create confusion and increase the possibility of certain private funds not clearly belonging to a single category. A category of hybrid funds would encapsulate an enormous diversity of funds, many of which would be more different from one another than they would be from liquid or illiquid funds, as defined in the rule. Additionally, new structures for private funds are constantly being developed, and there will certainly be new approaches in the future as well that are difficult to anticipate. It would likely be impractical to attempt to define characteristics of hybrid funds and thus to determine what performance metrics are necessary for them. We believe it is more effective to crystallize the key difference between liquid and illiquid funds in the final rule, as discussed above. In this regard, and as stated above, we believe that our simplification of the definition of “illiquid fund” in the final rule will result in fewer funds being mischaracterized than under the proposed definition, and thus this change in the final rule will reduce the need to create an additional category of hybrid funds to facilitate the categorization of private funds for performance reporting purposes.

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<sup>335</sup> See, *e.g.*, Morningstar Comment Letter; Convergence Comment Letter.

Other commenters requested that we let advisers choose the most appropriate approach with respect to performance reporting instead of requiring these categories.<sup>336</sup> A primary objective of the rule, however, is to provide the investors of a private fund with comparable performance information with respect to that fund and the investor's other private fund investments. Accordingly, we believe that establishing standardization with respect to a minimum level of sufficient disclosure is necessary. Currently, it may be difficult for certain investors to compare performance across their private fund investments if the investors are not large enough to negotiate for supplemental fund reporting or well-resourced enough to analyze in a timely manner the potential nuances in how different private funds present their performance. We believe that establishing a level of standardized performance reporting should make it easier for investors to evaluate their private fund investments and make more informed investment decisions.

The final rule requires advisers to provide performance reporting for each private fund as part of the fund's quarterly statement. The determination of whether a fund is liquid or illiquid dictates the type of performance reporting that must be included and, because it will result in funds with similar liquidity characteristics presenting the same type of performance metrics, this approach will improve comparability of private fund performance reporting for fund investors.

**a) Liquid Funds**

We are adopting the performance requirements for liquid funds as proposed, other than (i) the proposed requirement for an adviser to disclose annual net total returns since inception and (ii) the proposed use of calendar year reporting periods. Under the final rule, an adviser to a liquid fund is required to provide annual net total returns *since inception or for each*

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<sup>336</sup> See, e.g., BVCA Comment Letter; SBAI Comment Letter; AIMA/ACC Comment Letter.

*fiscal year over the 10 years prior to the quarterly statement, whichever is shorter.* As discussed in greater detail below, this change to the minimum number of years of required performance is responsive to commenters who stated that reporting since inception is overly broad and that many advisers would not have records going back to inception. Under the final rule, an adviser to a liquid fund must also provide performance metrics based on fiscal rather than calendar year reporting periods. As discussed in greater detail below,<sup>337</sup> the adoption of fiscal reporting periods seeks to align the delivery of the fourth quarter statement with the time that private funds obtain their audited annual financials. The adoption of fiscal reporting periods is also responsive to commenters who stated that fiscal periods would more closely align with industry practice.<sup>338</sup> While this modification may affect comparability for some investors across private funds with differing fiscal years, we understand that the majority of private funds' fiscal years match the calendar year and thus do not expect comparability to be substantially affected in most cases. We discuss each performance reporting requirement for liquid funds in turn below.

*Annual Net Total Returns.* The final rule requires advisers to liquid funds to disclose performance information in quarterly statements for specified periods. First, as noted above, an adviser to a liquid fund is required to disclose either the liquid fund's annual net total returns since inception or for each fiscal year over the 10 years prior to the quarterly statement, whichever is shorter. For example, a liquid fund that commenced operations four fiscal years ago would show annual net total returns for each of the first four fiscal years since its inception.

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<sup>337</sup> See section II.B.3.

<sup>338</sup> See, e.g., AIMA/ACC Comment Letter; ILPA Comment Letter I; SIFMA-AMG Comment Letter I (suggesting that the SEC require reporting only on an annual basis within 120 days of the fund's fiscal year end); GPEVCA Comment Letter (suggesting that any periodic disclosure requirement be tied to the annual audit process).

A liquid fund that commenced operations fourteen years ago, however, would be required to show annual net total returns only for each of the most recent 10 fiscal years.

Some commenters stated that the proposed requirement of performance since inception is unworkable.<sup>339</sup> In particular, certain commenters stated that certain longstanding funds may not have the necessary records to calculate the requisite performance metrics on an inception-to-date basis, particularly those records outside of the record-keeping requirements of the Advisers Act.<sup>340</sup> Another commenter suggested that, instead of annual returns since inception for liquid funds, we should require annual returns for the past 10 years.<sup>341</sup> We recognize that it may be difficult for certain longstanding liquid funds to calculate inception-to-date performance. Specifically, liquid funds that have been operating for decades might have to make significant estimations to be able to report inception-to-date performance if the relevant records have not been maintained over their entire life. While we believe there continues to be value in reporting inception-to-date performance even for longstanding funds, we also do not want liquid funds to be obligated to report inaccurate or misleading performance information based on estimates of performance from decades ago to investors. We agree with commenters that stated 10 years is an appropriate time period for liquid funds to report performance,<sup>342</sup> as it will capture the salient performance history in most cases and generally align with market practice and investor preferences, based on staff experience. A 10-year period should also generally still capture recent, relevant market cycles that may have affected performance. Accordingly, we are requiring only a minimum of 10 years of performance for liquid funds that have been in

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<sup>339</sup> See, e.g., ATR Comment Letter; AIMA/ACC Comment Letter.

<sup>340</sup> See, e.g., PWC Comment Letter; AIMA/ACC Comment Letter.

<sup>341</sup> See CFA Comment Letter I.

<sup>342</sup> See CFA Comment Letter II; Ropes & Gray Comment Letter.

operation for longer than that. Liquid funds are free, but not required, to report performance on a longer horizon than 10 years, if applicable.

Annual net total returns will provide fund investors with a comprehensive overview of the fund's performance over the life of the fund or the prior 10 years, whichever is shorter, and improve an investor's ability to compare the fund's performance with other similar funds. As noted above, investors can use performance information in connection with fee and expense information to analyze the value of their private fund investments. This requirement helps ensure that advisers do not present only recent performance results or only results for periods with strong performance. The rule also requires advisers to present each time period with equal prominence.

*Average Annual Net Total Returns.* Second, advisers to liquid funds are required to show each liquid fund's average annual net total returns over the one-, five-, and 10-year periods, as proposed.<sup>343</sup> If the private fund did not exist for any of these prescribed time periods, then the adviser is not required to provide the corresponding information. Requiring performance over these time periods will provide investors with standardized performance metrics that reflect how the private fund performed during different market or economic conditions. These time periods provide reference points for private fund investors, particularly when comparing two or more private fund investments, and provide private fund investors with aggregate performance information that can serve as a helpful summary of the fund's performance.

One commenter suggested that we should include a definition for "net total returns."<sup>344</sup> To the contrary, other commenters suggested that we should not prescribe how performance is

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<sup>343</sup> Final rule 211(h)(1)-2(e)(2)(i)(B).

<sup>344</sup> See CFA Comment Letter I.

calculated.<sup>345</sup> We think that defining “net total returns” for liquid funds in this rulemaking may not result in the best outcomes for investors. As used in the final rule, the liquid fund category captures a set of private funds that is unrestricted so long as they do not meet the definition of an illiquid fund and, as a result, is highly diverse. Some liquid funds target highly niche assets for which the calculation of net total returns is based on specialized industry norms and practices. Without further consideration and study, prescribing a single definition for “net total returns” could end up harming investors by distorting the reported performance of liquid funds that invest in less common asset classes from what investors have come to understand and expect. Consequently, we do not believe it is appropriate to prescribe a definition for “net total returns” at this time.

Certain commenters stated that requiring liquid funds to report the one-, five-, and 10-year periods would provide data to investors that the Commission recently determined in the marketing rule was not useful information for private funds.<sup>346</sup> One such commenter asserted that requiring the use of standardized reporting information to be presented alongside the more relevant data would result in multiple sets of performance data and metrics, creating additional confusion for investors and an overwhelming volume of information.<sup>347</sup> While we acknowledge that the marketing rule excepted private funds from its one-, five-, and 10- year periods presentation requirement, the underlying concern with requiring these intervals was that it could be not useful or meaningful, and possibly confusing, for investors in a closed-end fund.<sup>348</sup>

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<sup>345</sup> See, e.g., GPEVCA Comment Letter; BVCA Comment Letter.

<sup>346</sup> See, e.g., IAA Comment Letter II; NYC Bar Comment Letter II; PIFF Comment Letter; Schulte Comment Letter. See also Marketing Release, *supra* footnote 127, at 182.

<sup>347</sup> See PIFF Comment Letter.

<sup>348</sup> See Marketing Release, *supra* footnote 127, at 181-182.

Among our reasons for excepting *all* private funds from the requirement under the marketing rule, we stated that we did not believe the benefit of having advisers parse the rule's requirements based on specific fund types would justify the complexity.<sup>349</sup> Performance information in the quarterly statements serves a somewhat different purpose, however. As stated above, the needs of *current* clients and investors often differ in some respects from the needs of *prospective* clients and investors. Current investors generally need to receive performance reporting during different time periods to be able to evaluate properly an investment's performance. Current investors also generally need to receive performance reporting that is provided at timely, predictable intervals to be able to compare information effectively from quarter to quarter and year to year, and thus be positioned to take action where possible. Requiring regular disclosure of performance for liquid funds over these periods will help prevent fraud, deception, and manipulation because timely and consistent performance information will decrease the likelihood that investors will be defrauded, deceived, or manipulated by deceptive or misleading representations of performance, especially if such representations occur with respect to each time period.<sup>350</sup> It also increases the likelihood that any misconduct will be detected sooner. Accordingly, the final rule will retain the one-, five- and 10-year periods for liquid funds because we believe they will assist investors with this process.

*Cumulative Net Total Returns.* Third, the adviser is required to show the liquid fund's cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement. For example, a liquid fund that has been in operation

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<sup>349</sup> *See id.*

<sup>350</sup> For example, if performance suddenly and dramatically improves without explanation, then investors will be in a better position (especially where there are comparable benchmarks that did not experience the same sudden and dramatic change) to ask advisers to provide an explanation and assess whether fraud, deception or manipulation may be occurring.



for four fiscal years (beginning on January 1) and seven months would show, pursuant to this requirement, the cumulative net total return for the current fiscal year through the end of the second quarter (*i.e.*, year-to-date fund performance as of the end of the most recent fiscal quarter covered by the quarterly statement). This information will provide fund investors with insight into the fund's most recent performance, which investors can use to assess the fund's performance during recent market conditions. This quarterly performance information will also provide helpful context for reviewing and monitoring the fees and expenses borne by the fund during recent quarters, which the quarterly statement will disclose.

These required performance metrics should allow investors to better assess these funds' performance. Liquid funds generally should be able to determine their net asset value on a regular basis and compute the year-over-year return using the market-based value of the underlying assets. We have taken a similar approach with regard to registered open-end funds, which typically invest a substantial amount of their assets in primarily liquid underlying holdings (*e.g.*, publicly traded securities).<sup>351</sup> Liquid funds, like registered funds, currently generally report performance, at a minimum, on an annual and quarterly basis. Investors in a private fund that is a liquid fund would similarly find this information helpful. Most traditional hedge funds are likely liquid funds and will need to provide disclosures regarding the underlying assumptions of the performance (*e.g.*, whether dividends or other distributions are reinvested).<sup>352</sup>

One commenter suggested that we should reevaluate the requirement for liquid funds to show both annualized and cumulative net performance and grant private funds flexibility in

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<sup>351</sup> See, *e.g.*, Item 4(b)(2) of Form N-1A.

<sup>352</sup> See *supra* the discussion of the definition of "liquid fund" in section II.B.2.

providing either annualized or cumulative net performance.<sup>353</sup> We decided not to allow this flexibility to help ensure that investors receive standardized, comparable information for each private fund. Permitting advisers to pick and choose which return metrics to use would be inconsistent with this goal. Accordingly, as proposed, the final rule will require advisers to show both annualized and cumulative net performance.

Another commenter suggested that we should also require liquid funds to provide average annual net returns over a three-year period in addition to the one-, five- and 10-year periods to potentially provide additional transparency to private fund investors.<sup>354</sup> Although we recognize that additional performance information may serve to enhance the overall amount of information available to investors, we believe that the presentation of standardized performance information for one-, five- and 10-year periods will provide a sufficient level of minimum disclosure (which may be further supplemented) for private fund investors to monitor and gain insight into how a private fund performed during different market or economic conditions.<sup>355</sup>

#### **b) Illiquid Funds**

We are adopting the performance requirements for illiquid funds largely as proposed, other than the requirement for an adviser to disclose performance figures solely *without* the impact of fund-level subscription facilities. Under the final rule, an adviser is required to disclose performance figures *with and without* the impact of fund-level subscription facilities. As discussed in greater detail below, this change is responsive to commenters who stated that

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<sup>353</sup> See SIFMA-AMG Comment Letter I.

<sup>354</sup> See Morningstar Comment Letter.

<sup>355</sup> We also note that advisers are able to provide, and investors are free to request and negotiate for, average annual net returns over a three-year period, provided that such additional reporting complies with other regulations, such as the final marketing rule when applicable. See *supra* the introductory discussion in section II.B.2.

reporting both sets of performance figures would provide investors with a more complete picture of the fund's performance. We discuss each performance reporting requirement for illiquid funds in turn below.

The rule requires advisers to illiquid funds to disclose the following performance measures in the quarterly statement, shown since inception of the illiquid fund and computed *with and without* the impact of any fund-level subscription facilities:<sup>356</sup>

- (i) Gross internal rate of return and gross multiple of invested capital for the illiquid fund;
  - (ii) Net internal rate of return and net multiple of invested capital for the illiquid fund;
- and
- (iii) Gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.

The rule also requires advisers to provide investors with a statement of contributions and distributions for the illiquid fund.<sup>357</sup>

*Since Inception.* The rule requires an adviser to disclose the illiquid fund's performance measures since inception. This requirement will ensure that advisers are not providing investors with only recent performance results or presenting only results or periods with strong performance, which could mislead investors. We are requiring this for all illiquid fund

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<sup>356</sup> One commenter recommended that we should clarify how distributions that are recalled by advisers for additional investments (often referred to as "recycling") should be treated for certain of these illiquid fund performance metrics. *See* CFA Comment Letter II. Advisers generally should treat any distributions that they recall for additional investments as additional contributions for purposes of calculating these illiquid fund performance metrics as we understand this is the expectation of investors. As a result, illiquid fund performance information that does not treat such recalled distributions as additional contributions may be misleading.

<sup>357</sup> Final rule 211(h)(1)-2I(2)(ii).

performance measures under the rule, including the performance measures for the realized and unrealized portions of the illiquid fund's portfolio.

The rule requires an adviser to include performance measures for the illiquid fund through the end of the quarter covered by the quarterly statement. We recognize, however, that certain funds may need information from portfolio investments and other third parties to generate performance data and thus may not have the necessary information prior to the distribution of the quarterly statement. Accordingly, to the extent quarter-end numbers are not available at the time of distribution of the quarterly statement, an adviser is required to include performance measures through the most recent practicable date, which we generally believe would be through the end of the quarter immediately preceding the quarter covered by the quarterly statement. The rule requires the quarterly statement to reference the date the performance information is current through (*e.g.*, December 31, 2023).<sup>358</sup>

Some commenters supported the since inception performance disclosure requirement for illiquid funds,<sup>359</sup> while other commenters criticized it.<sup>360</sup> One commenter commented specifically on the since inception requirement for illiquid fund performance, stating that we should retain this requirement because inception-to-date returns allow investors to understand the improvement or deterioration of returns over the most relevant period, especially for illiquid funds with long-hold periods.<sup>361</sup> We believe that it is important for illiquid funds to provide performance information since inception so that investors are able to evaluate the full performance of their investment. For many illiquid funds, investors commit capital at or near the

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<sup>358</sup> Final rule 211(h)(1)-2(e)(2)(iii).

<sup>359</sup> *See, e.g.*, Trine Comment Letter; AFREF Comment Letter I; IST Comment Letter.

<sup>360</sup> *See, e.g.*, IAA Comment Letter II; PIFF Comment Letter; AIMA/ACC Comment Letter.

<sup>361</sup> *See* CFA Comment Letter II.

inception of the fund.<sup>362</sup> These same investors generally also contribute the capital used to make the fund’s initial investments. Accordingly, anything less than performance since inception would misrepresent the performance of such investors’ investments in the illiquid fund. While there may be situations where investors make capital commitments to an illiquid fund later on in its life, we understand that these circumstances are rare. Even in these scenarios, the illiquid fund may have already made most of the investments it will make over its life by the time this capital is committed later in its life. We also agree with this commenter that inception-to-date returns allow investors to better assess performance trends, particularly for illiquid funds, since inception performance will generally align with the typical investment holding period and the period for which the performance-based fee is generally calculated for many illiquid funds. Accordingly, we maintain that performance since inception is the best approach for representing the illiquid fund’s performance.

*Computed With and Without the Impact of Fund-Level Subscription Facilities.* The rule requires advisers to calculate performance measures for each illiquid fund both with and without the impact of fund-level subscription facilities.<sup>363</sup> For performance measures *without* the impact of fund-level subscription facilities (“unlevered returns”), the rule requires advisers to calculate performance measures as if the private fund called investor capital, rather than drawing down on fund-level subscription facilities, as proposed.<sup>364</sup> For performance measures *with* the impact of fund-level subscription facilities (“levered returns”), the rule requires advisers to calculate

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<sup>362</sup> Investors that enter an illiquid fund in a closing subsequent to the fund’s initial closing are also generally subject to types of equalization payments or adjustments (e.g., “true-ups”) that result in their treatment by the private fund as if they had entered the fund at its initial closing.

<sup>363</sup> Final rule 211(h)(1)-2(e)(2)(ii)(A).

<sup>364</sup> As discussed below, the rule also requires advisers to prominently disclose the criteria used and assumptions made in calculating performance. This includes the criteria and assumptions used to prepare an illiquid fund’s unlevered performance measures.

performance measures reflecting the actual capital activity from both investors and fund-level subscription facilities, including, for the avoidance of doubt, any activity prior to investor capital contributions as a result of the fund drawing down on fund-level subscription facilities.

In response to our requests for comment, a number of commenters suggested that we require performance measures for illiquid funds both with and without the impact of fund-level subscription facilities.<sup>365</sup> Of these, one commenter stated that requiring performance measures for illiquid funds both with and without the impact of fund-level subscription facilities would provide a more complete picture of the effects of a fund’s financing strategies.<sup>366</sup> Another commenter stated that this approach would allow investors to understand the impact of the adviser’s decision to use a subscription facility.<sup>367</sup> In response to commenters, we are requiring advisers to calculate performance measures for each illiquid fund both with and without the impact of fund-level subscription facilities. As one commenter pointed out, an internal rate of return *with* the impact of the subscription facilities is typically used to calculate performance-based compensation, and this return also usually reflects the actual investor return.<sup>368</sup> Accordingly, after considering comments, we think it is necessary for investors to be able to compare their illiquid fund performance both with and without the impact of fund-level

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<sup>365</sup> See, e.g., ILPA Comment Letter I; Comment Letter of Predistribution Initiative (Apr. 25, 2022) (“Predistribution Initiative Comment Letter II”); IST Comment Letter.

<sup>366</sup> See Predistribution Initiative Comment Letter II.

<sup>367</sup> See CFA Comment Letter I. However, this commenter also stated that, in certain cases, the calculation of performance without the impact of subscription facilities could be challenging, particularly for historical periods. The commenter stated that advisers may need to make assumptions about which historical capital calls would have been impacted. Because the final rule requires advisers to disclose any assumptions used in calculating performance, we believe that investors will be able to analyze the assumptions made and weigh their impact on performance. Nonetheless, we recognize that, to the extent these assumptions by advisers are not accurate, the benefits of the information to investors may be reduced. See *infra* section VI.D.2.

<sup>368</sup> See CFA Comment Letter I.

subscription facilities to better understand how the use and costs of any fund-level subscription facilities are affecting their returns. Because most advisers with fund-level subscription facilities are already reporting performance with the impact of such facilities, we do not anticipate that this requirement will entail substantial additional burdens for most advisers.<sup>369</sup>

Some commenters suggested exempting advisers from the requirement to present unlevered returns to the extent they used subscription facilities on a short term basis to efficiently manage capital, rather than to increase returns.<sup>370</sup> Of these, some stated that this exemption would be for advisers using facilities solely or primarily to streamline capital calls and not to enhance performance.<sup>371</sup> Some commenters suggested that a “short-term” subscription facility is generally one for which the facility is repaid within 120 days using committed capital that is drawn down through a capital call.<sup>372</sup> While we acknowledge that some short-term subscription facilities may be less likely to cause the issues we discuss below, providing such an exemption could lead to certain undesirable outcomes. For instance, a fund may only repay each use of a subscription facility within 120 days for the first two years of the fund’s life but then start leaving such subscription facility unpaid for longer spans of time for the remaining eight years of its life. If we were to provide such an exemption, such a fund would not be required to show unlevered performance measures for the first two years but then would be required to do so in the third year. However, in year three and after, investors would only have past levered performance measures and may find it difficult to assess the newly received unlevered performance measures. Additionally, it is important that investors understand how costs

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<sup>369</sup> See *infra* section VI.D.2.

<sup>370</sup> See, e.g., CFA Comment Letter I; AIC Comment Letter II; ILPA Comment Letter I.

<sup>371</sup> See, e.g., AIC Comment Letter II; ILPA Comment Letter I.

<sup>372</sup> See, e.g., CFA Comment Letter I; ILPA Comment Letter I.

associated with a subscription facility are affecting performance, and the unlevered performance measures will facilitate this understanding.

As proposed, we are defining “fund-level subscription facilities” as any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness incurred by the private fund that is secured by the unfunded capital commitments of the private fund’s investors.<sup>373</sup> This definition is designed to capture the various types of subscription facilities prevalent in the market that serve as temporary replacements or substitutes for investor capital.<sup>374</sup> Such facilities enable the fund to use loan proceeds – rather than investor capital – to fund investments initially and pay expenses. This practice permits the fund to delay the calling of capital from investors, which has the potential to increase performance metrics artificially.

Many advisers currently provide performance figures that reflect the impact of fund-level subscription facilities. We believe that these “levered” performance figures, alone, have the potential to mislead investors.<sup>375</sup> For example, an investor could reasonably believe that levered performance results are similar to those that the investor has achieved from its investment in the

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<sup>373</sup> Final rule 211(h)(1)-1. The rule defines “unfunded capital commitments” as committed capital that has not yet been contributed to the private fund by investors, and “committed capital” as any commitment pursuant to which a person is obligated to acquire an interest in, or make capital contributions to, the private fund. *See id.*

<sup>374</sup> We recognize that a private fund may guarantee portfolio investment indebtedness. In such a situation, if the portfolio investment does not have sufficient cash flow to pay its debt obligations, the fund may be required to cover the shortfall to satisfy its guarantee. Even though investors’ unfunded commitments may indirectly support the fund’s guarantee, the definition would not cover such fund guarantees. Unlike fund-level subscription facilities, such guarantees generally are not put in place to enable the fund to delay the calling of investor capital.

<sup>375</sup> We recognize that fund-level subscription facilities can be an important cash management tool for both advisers and investors. For example, a fund may use a subscription facility to reduce the overall number of capital calls and to enhance its ability to execute deals quickly and efficiently.



fund. Unlevered performance figures, when presented alongside levered performance figures, will provide investors with more meaningful data and improve the comparability of returns.

We stated in the proposal that we would generally interpret the phrase computed without the impact of fund-level subscription facilities to require advisers to exclude fees and expenses associated with the subscription facility, such as the interest expense, when calculating net performance figures and preparing the statement of contributions and distributions. One commenter suggested that excluding subscription line fees and expenses from net performance should be optional, rather than required.<sup>376</sup> On the contrary, allowing such flexibility would degrade comparability and standardization. In addition, this approach is appropriate because it will result in returns that show what the fund would have achieved if there were no subscription facility, which will help investors understand the impact of the use of the subscription facility.

While there may be certain circumstances under which including subscription line fees and expenses in unlevered performance metrics may have advantages, standardization is important. If we were to make the exclusion of subscription line fees and expenses from net performance for illiquid funds optional instead of required, some advisers might include such fees and expenses while others might exclude them. This variability could make it difficult for investors to assess unlevered performance metrics across illiquid funds that are managed by different advisers. Additionally, some advisers might start by including subscription line fees and expenses from unlevered performance metrics and then switch to excluding such fees and

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<sup>376</sup> See CFA Comment Letter I. This commenter stated that it could be challenging to identify all activity related to these subscription facilities for those advisers that have not previously calculated internal rates of return without the impact of subscription facilities, particularly for funds with long histories. While we acknowledge these calculations could be challenging in certain instances, we believe these burdens are justified by the benefits of improved comparability and standardization across quarterly statements. Moreover, we also believe that these challenges will lessen as older funds wind down.

expenses if there was a downward trend in performance. This potential gamesmanship could mislead investors. Accordingly, we are not allowing such optionality.

*Fund-Level Performance.* The rule requires an adviser to disclose an illiquid fund’s gross and net internal rate of return and gross and net multiple of invested capital for the illiquid fund. We are adopting the entirety of this portion of the rule, including all definitions discussed below, as proposed.

Some commenters supported this performance disclosure requirement as providing a useful component in the totality of information that would be required to be provided to private fund investors under the rule.<sup>377</sup> Other commenters criticized this performance disclosure requirement on a number of grounds.<sup>378</sup> One commenter stated that we should prohibit the use of internal rates of return and multiples of invested capital because they can be flawed performance metrics,<sup>379</sup> and another commenter indicated that these performance metrics may not be meaningful in the early stages of a fund until it has had time to deploy its capital and generate returns.<sup>380</sup> Finally, certain commenters stated that advisers and investors should retain discretion to determine appropriate performance metrics.<sup>381</sup>

We recognize that most illiquid funds have particular characteristics, such as irregular cash flows, that make measuring performance difficult for both advisers and investors. We also recognize that internal rate of return and multiple of invested capital have their drawbacks as

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<sup>377</sup> See, e.g., ICCR Comment Letter; AFREF Comment Letter I; NEA and AFT Comment Letter.

<sup>378</sup> See, e.g., SBAI Comment Letter; PIFF Comment Letter; AIMA/ACC Comment Letter.

<sup>379</sup> See Comment Letter of SOC Investment Group (Apr. 25, 2022) (“SOC Comment Letter”).

<sup>380</sup> See AIC Comment Letter II.

<sup>381</sup> See, e.g., PIFF Comment Letter; SBAI Comment Letter.

performance metrics.<sup>382</sup> Nonetheless, we continue to believe that, received together, these metrics complement one another.<sup>383</sup> Moreover, these metrics, combined with a statement of contributions and distributions reflecting cash flows discussed below, will help investors holistically understand the fund’s performance, allow investors to diligence the fund’s performance, and calculate other performance metrics they may find helpful. When presented in accordance with the conditions and other disclosures required under the rule, such standardized reporting measures will provide meaningful performance information for investors, allowing them to compare returns among funds that they are invested in and make more-informed decisions with respect to, for example, other components of their portfolios or whether or not to invest with the same adviser in the future. Accordingly, we are adopting this aspect of the rule as proposed.

As proposed, we are defining “internal rate of return” as the discount rate that causes the net present value of all cash flows throughout the life of the private fund to be equal to zero.<sup>384</sup> Cash flows will be represented by capital contributions (*i.e.*, cash inflows) and fund distributions (*i.e.*, cash outflows), and the unrealized value of the fund will be represented by a fund distribution (*i.e.*, a cash outflow). This definition will provide investors with a time-adjusted

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<sup>382</sup> Primarily, multiple of invested capital does not factor in the amount of the time it takes for a fund to generate a return, and internal rate of return assumes early distributions will be reinvested at the same rate of return generated at the initial exit.

<sup>383</sup> By receiving both an internal rate of return and a multiple of invested capital, an investor will be able to use each performance metric to assess the limitations of the other. For example, a high multiple of invested capital but a low internal rate of return likely means that returns are low compared to the length of time the investment has been held. Similarly, a high internal rate of return but a low multiple of invested capital likely means that the investment was not held long enough to generate substantial returns for the fund.

<sup>384</sup> Final rule 211(h)(1)-1 (defining “gross IRR” and “net IRR”).

return that takes into account the size and timing of a fund’s cash flows and its unrealized value at the time of calculation.<sup>385</sup>

We are defining “multiple of invested capital” as (i) the sum of: (A) the unrealized value of the illiquid fund; and (B) the value of all distributions made by the illiquid fund; (ii) divided by the total capital contributed to the illiquid fund by its investors.<sup>386</sup> This definition will provide investors with a measure of the fund’s aggregate value (*i.e.*, the sum of clauses (i)(A) and (i)(B)) relative to the capital invested (*i.e.*, clause (ii)) as of the end of the applicable reporting period, as proposed. Unlike the definition of internal rate of return, the multiple of invested capital definition does not take into account the amount of time it takes for a fund to generate a return (meaning that the multiple of invested capital measure focuses on “how much” rather than “when”).

We received few comments on the proposed definitions, with one commenter stating that neither definition takes into account the timing of fund transactions.<sup>387</sup> Another commenter argued that definitions were unnecessary because investors have their own methods for calculating internal rate of return and multiple of invested capital, and that advisers typically provide investors with sufficient information to calculate performance already.<sup>388</sup> After considering comments, we believe that the proposed definitions of internal rate of return and

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<sup>385</sup> When calculating a fund’s internal rate of return, an adviser will need to take into account the specific date a cash flow occurred (or is deemed to occur). Certain electronic spreadsheet programs have “XIRR” or other similar formulas that require the user to input the applicable dates.

<sup>386</sup> Final rule 211(h)(1)-1 (defining “gross MOIC” and “net MOIC”).

<sup>387</sup> *See* Comment Letter of XTAL Strategies (Feb. 28, 2022) (“XTAL Comment Letter”). As discussed in greater detail below in Section VI.C.3, this commenter provided examples where multiple funds with different distribution timings had the same internal rates of return. However, we were not persuaded by this commenter because the fact that it is possible to construct examples in which two funds with different timings of payments can have the same internal rates of return does not mean that such performance metric broadly fails to take into account the timing of transactions.

<sup>388</sup> *See* AIC Comment Letter II.

multiple of invested capital are appropriate because they will promote comparability and standardization. As stated in the proposal, the definitions are generally consistent with how the industry currently calculates such performance metrics. By adopting definitions that are widely understood and accepted in the industry, the rule will decrease the risk of advisers presenting internal rate of return and multiple of invested capital performance figures that are not comparable. Furthermore, the rule will not prevent an adviser from providing information or performance metrics in addition to those required by the rule (subject to other requirements applicable to the adviser) or an investor from using such additional information or metrics for its own calculations.

As proposed, the final rule requires advisers to present each performance metric on a gross and net basis.<sup>389</sup> Commenters were generally supportive of this requirement.<sup>390</sup> Presenting both gross and net performance measures will help prevent investors from being misled. Gross performance will provide insight into the profitability of underlying investments selected by the adviser. Solely presenting gross performance, however, may imply that investors have received the full amount of such returns. The net performance will assist investors in understanding the actual returns received and, when presented alongside gross performance, the negative effect fees, expenses, and performance-based compensation have had on past performance.

*Statement of Contributions and Distributions.* The rule also requires an adviser to provide a statement of contributions and distributions for the illiquid fund reflecting the

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<sup>389</sup> Final rule 211(h)(1)-2(e)(2)(ii).

<sup>390</sup> See, e.g., NEA and AFT Comment Letter (noting “[s]tandardized reporting of the internal rate of return (IRR) and the multiple of capital (MoC) invested, both gross and net of fees and considering the use of subscription credit lines, would mark a leap forward in transparency.”); see also AFL-CIO Comment Letter; ICM Comment Letter; ILPA Comment Letter I.

aggregate cash inflows from investors and the aggregate cash outflows from the fund to investors, along with the fund’s net asset value, as proposed.<sup>391</sup>

We are defining a statement of contributions and distributions as a document that presents:

(i) All capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund’s inception, with the value and date of each inflow and outflow; and

(ii) The net asset value of the private fund as of the end of the reporting period covered by the quarterly statement.<sup>392</sup>

Some commenters supported the requirement to provide a statement of contributions and distributions.<sup>393</sup> Other commenters criticized specific parts of this requirement.<sup>394</sup> One commenter suggested that the statement of contributions and distributions would be of limited value to private fund investors and is not often currently requested by private fund investors,<sup>395</sup> whereas another commenter conversely suggested that private fund investors typically already receive information beyond what we are requiring to be included in the statement of contributions and distributions.<sup>396</sup> Another commenter suggested that we provide flexibility with respect to the requirement that the statement of contributions and distributions include the date of

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<sup>391</sup> At proposal, the statement of contributions and distributions requirement was listed as rule 211(h)(1)-2(e)(2)(ii)(A)(4). At adoption, we have changed the statement of contributions and distributions requirement to rule 211(h)(1)-2(e)(2)(ii)(B). We have made this change for clarification as a statement of contributions and distributions is not a “performance measure” that can be “computed” as rule 211(h)(1)-2(e)(2)(ii)(A) is phrased.

<sup>392</sup> Final rule 211(h)(1)-1.

<sup>393</sup> See, e.g., CFA Comment Letter I; OFT Comment Letter.

<sup>394</sup> See, e.g., IAA Comment Letter II; PIFF Comment Letter.

<sup>395</sup> See IAA Comment Letter II.

<sup>396</sup> See ILPA Comment Letter I.

each cash inflow and outflow, in light of the possibility that older cash flow information may have been recorded by certain advisers using legacy systems that assumed that all cash flows during a certain period occurred on the last day of such period.<sup>397</sup>

We believe that the statement of contributions and distributions will provide private fund investors with important information regarding the fund's performance, because it will reflect the underlying data used by the adviser to generate the fund's returns, which, in many cases, is not currently provided to private fund investors. Such data will allow investors to diligence the various performance measures presented in the quarterly statement. In addition, this data will allow the investors to calculate additional performance measures based on their own preferences.

Some commenters suggested that subscription facility fees and expenses should be included in the statement of contributions and distributions.<sup>398</sup> At proposal, we had required private fund advisers to exclude such fees and expenses because we had proposed to require only unlevered performance metrics for illiquid funds and believed that the statement of contributions and distributions should directly align with these unlevered performance metrics. As we are requiring both levered and unlevered performance to be included in the quarterly statement for illiquid funds under the final rule, advisers should consider including in the statement of contributions and distributions any fees and expenses related to a subscription facility.

One commenter suggested that we should require additional detail in the statement of contributions and distributions.<sup>399</sup> We believe that it is important that the statement of

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<sup>397</sup> See CFA Comment Letter II.

<sup>398</sup> See, e.g., CFA Comment Letter I; AIC Comment Letter II.

<sup>399</sup> See XTAL Comment Letter. This commenter specifically suggested we require the inclusion of additional information such as uncalled commitment, cumulated distributions, and net of performance fee accruals. While they are helpful, we view these additional requirements as potentially overly burdensome relative to their benefits since they are not necessary for investors to diligence the performance measures presented in the quarterly statement.

contributions and distributions provide sufficient information to enable investors to conduct due diligence on the various performance measures presented in the quarterly statement and to potentially perform their own additional performance calculations. Investors will need the dates and amounts of subscription facility drawdowns to be able to calculate unlevered returns. As such, we view these dates and amounts as providing investors critical information necessary to perform these calculations on their own. Although we are not prescribing additional particular information to be disclosed beyond what was included in the proposal, advisers may wish to consider also providing other details they believe investors would find relevant in the statement of contributions and distributions, such as information about how each contribution and distribution was used and the dates of drawdowns from fund-level subscription facilities.

*Realized and Unrealized Performance.* As proposed, the rule also requires an adviser to disclose a gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.<sup>400</sup>

Some commenters supported this requirement to disclose realized and unrealized performance metrics for illiquid funds as contributive to the policy goals of transparency and comparability of private fund investments promoted by the rule.<sup>401</sup> Other commenters suggested, however, that this requirement could serve to undermine these goals and prove unhelpful to private fund investors, because disaggregating an illiquid fund's realized performance and its unrealized performance ultimately may involve subjective determinations<sup>402</sup>

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<sup>400</sup> Final rule 211(h)(1)-2(e)(2)(ii)(A)(3).

<sup>401</sup> See, e.g., ILPA Comment Letter I; AFL-CIO Comment Letter; AFREF Comment Letter I; CFA Comment Letter I.

<sup>402</sup> See, e.g., AIC Comment Letter I; AIC Comment Letter II; IAA Comment Letter II; SBAI Comment Letter.



and will depend on the specific facts and circumstances.<sup>403</sup> One commenter stated that, if we adopt this requirement, we should also provide a detailed methodology for calculating realized and unrealized performance.<sup>404</sup> Other commenters suggested allowing advisers to take a flexible approach with respect to determining what investments are realized versus unrealized provided that their methodology is properly documented and disclosed.<sup>405</sup>

We recognize that it may be difficult to determine whether a partially realized investment has been realized under the final rule, for example, following a significant dividend recapitalization where the fund recoups all or a substantial portion of its initial investment. We continue to believe, however, that disclosure of realized and unrealized performance will provide investors with important context for analyzing the adviser's valuations and for weighing their impact on the fund's overall performance.<sup>406</sup> As a result, we believe that the burden associated with determining whether a partially realized investment should be categorized as realized or unrealized is justified by the benefits that this performance data will provide to investors.

We recognize that categorizing a partially realized investment as realized or unrealized for purposes of the rule will depend on the facts and circumstances and may not always be purely objective. We agree with commenters that it is valuable for advisers to have some discretion in determining whether an investment has been realized for purposes of the rule based on the

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<sup>403</sup> See, e.g., AIC Comment Letter II; ATR Comment Letter.

<sup>404</sup> See NCREIF Comment Letter.

<sup>405</sup> See, e.g., AIC Comment Letter II; SBAI Comment Letter; CFA Comment Letter I.

<sup>406</sup> As stated in the proposal, the value of the unrealized portion of an illiquid fund's portfolio typically is determined by the adviser and, given the lack of readily available market values, can be challenging. This creates a conflict of interest wherein the adviser may be evaluated and, in certain cases, compensated based on the fund's unrealized performance. Further, investors often decide whether to invest in a successor fund based on a current fund's performance as reported by the adviser. These factors create an incentive for the adviser to inflate the value of the unrealized portion of the illiquid fund's portfolio. See Proposing Release *supra* footnote 3, at n.9, 74-75.

specific facts and circumstances, provided that their methodology is properly documented.<sup>407</sup> It is also important that advisers remain consistent in how they determine realized and unrealized investments and that they provide sufficient disclosure to investors about the methodology and criteria they use to achieve consistency in their determinations. We do not believe it is appropriate to set a bright-line standard or otherwise prescribe detailed methodology for making this determination because any such standard or methodology may lead to less useful reporting for investors.<sup>408</sup> For example, it is our understanding that the methodologies used by private equity buy-out funds, private credit funds,<sup>409</sup> and their respective investors to determine realization can vary considerably. A private equity buy-out fund and its investors may seek to analyze realization as it relates to the sale of a portfolio company (or return of a certain amount of proceeds relative to the amount invested or anticipated to be invested), whereas a private credit fund and its investors may seek to analyze realization as it relates to a paydown of a portion of the principal balance of a loan. If we were to prescribe one methodology for both of these funds and their investors, it may lead to scenarios in which there is a conflict between how the rule views realization and how these funds and their investors view realization. Such a result could lead to worse reporting outcomes for investors.<sup>410</sup>

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<sup>407</sup> The methodology used to determine whether an investment is realized or unrealized is an important criterion to calculate this required performance information. Accordingly, it must be prominently disclosed in the quarterly statement. Final rule 211(h)(1)-2(e)(2)(iii).

<sup>408</sup> For example, if we were to set an 100% threshold for determining when an investment has been fully realized, this may lead to reporting that is too high as compared to what investors have negotiated for or what they have come to expect for certain private funds (or too low if we set the percentage threshold lower). If we were to establish a realization test based on a different trigger (*e.g.*, the sale of a portfolio investment) it might not be applicable for certain kinds of private funds (*e.g.*, private credit funds that primarily make loans).

<sup>409</sup> These examples refer to private credit funds that issue equity interests to investors and invest in debt instruments privately issued by companies.

<sup>410</sup> Based on the experience of Commission staff, it is our understanding that investors generally do not seek to compare realization methodologies across different types of illiquid funds in the same way that they might

One commenter suggested requiring reporting of distributions to paid-in capital (“DPI”) and residual value to paid-in capital (“RVPI”) instead of gross multiple of invested capital (“MOIC”) for realized and unrealized investments.<sup>411</sup> As discussed in the proposal, some advisers have an incentive to inflate the value of the unrealized portion of an illiquid fund’s portfolio. Highlighting the performance of the fund’s unrealized investments assists investors in determining whether the aggregate, fund-level performance measures present an overly optimistic view of the fund’s overall performance.<sup>412</sup> While we recognize that DPI and RVPI may provide some potentially beneficial, additional information, these metrics may not be as effective at highlighting potentially overly optimistic valuations. RVPI, for example, provides investors with information on the fund’s residual value *relative to the amount of capital that has been paid in*, including paid-in capital attributable to the realized portion of the portfolio.<sup>413</sup> MOIC for unrealized portion of the portfolio, on the other hand, provides investors with information on the fund’s residual value *relative to the capital that has been contributed in respect of the unrealized investments*, which has the effect of highlighting the adviser’s valuations of the remaining investments relative to those capital contributions only.

Accordingly, we believe that gross MOIC for realized and unrealized investments provides more

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for performance reporting. As a result, it is not as important to ensure comparability of realization methodologies across different types of illiquid funds as it is to ensure comparability of performance reporting.

<sup>411</sup> See CFA Comment Letter II. RVPI plus DPI equal total value to paid-in capital (“TVPI”), while unrealized MOIC and realized MOIC must be combined as a weighted average to yield total MOIC. For TVPI, the unrealized and realized analogues are RVPI and DPI ratios, and the denominator in both of these cases is the total called capital of the entire fund. For MOIC, unrealized and realized MOIC have as denominators just the portions of the called capital attributable to unrealized and realized investments in the portfolio.

<sup>412</sup> For example, if the performance of the unrealized portion of the fund’s portfolio is significantly higher than the performance of the realized portion, it may imply that the adviser’s valuations are overly optimistic or otherwise do not reflect the values that can be realized in a transaction or sale with an independent third party.

<sup>413</sup> DPI is not effective at highlighting overly optimistic valuations because it focuses on distributions (and not residual value) relative to paid in capital.

direct information on the differences between the actual distributions received by investors from the realized portfolio and the *adviser's valuations* of the unrealized portfolio. This approach better addresses our concerns surrounding advisers' incentive to inflate the value of the unrealized portion of an illiquid fund's portfolio.

The rule only requires an adviser to disclose gross performance measures for the realized and unrealized portions of the illiquid fund's portfolio, as proposed. Commenters generally agreed with this approach.<sup>414</sup> We continue to believe that calculating net figures for the realized and unrealized portions of the portfolio could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees, expenses, and adviser compensation between the realized and unrealized portions.<sup>415</sup> In our view, such assumptions have the potential to erase the benefits that net performance measures would provide.

### **c) Prominent Disclosure of Performance Calculation Information**

As proposed, the final rule will require advisers to include prominent disclosure of the criteria used and assumptions made in calculating the performance. This information will enable the private fund investor to understand how the performance is calculated and help provide useful context for the presented performance metrics. Additionally, while the rule includes detailed information about the type of performance an adviser must present for liquid and illiquid funds, it is still possible that advisers will make certain assumptions or rely on criteria that the rule's requirements do not address specifically. This information is integral to the quarterly

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<sup>414</sup> See, e.g., AIMA/ACC Comment Letter; AIC Comment Letter II.

<sup>415</sup> The inclusion of realized and unrealized performance information in the quarterly statement serves chiefly to provide a comparison between the two and provide a check against advisers' exaggeration of unrealized performance at the fund-level. We believe this is achieved by requiring only gross realized and unrealized performance without also requiring net performance and the associated assumptions, such as the allocation of organizational expenses, that are part of the calculation of net performance for individual investments and can entail additional costs and subjectivity.

statement because it will enable the investor to understand and analyze the performance information better and better compare the performance of funds and advisers without having to access other ancillary documents. As a result, investors should receive this information as part of the quarterly statement itself.

For example, the rule requires an adviser to display, for a liquid fund, the annual returns for each fiscal year over the past 10 years or since the fund's inception, whichever is shorter. If the adviser makes any assumptions in performing that calculation, such as whether dividends were reinvested, the adviser must disclose those assumptions in the quarterly statement. As another example, for an illiquid fund, the rule requires an adviser to present the net internal rate of return and net multiple of invested capital. Correspondingly, the adviser must disclose the use of any assumed fee rates, including whether the adviser is using fee rates set forth in the fund documents, whether it is using a blended rate or weighted average that would factor in any discounts, or whether it is using a different method for calculating net performance. The rule requires the disclosure to be within the quarterly statement.<sup>416</sup> Thus, an adviser may not provide the information only in a separate document, website hyperlink or QR code, or other separate disclosure.<sup>417</sup>

Some commenters supported this requirement to include prominent disclosure of the criteria used and assumptions made in calculating the performance.<sup>418</sup> Other commenters stated that such a requirement is unnecessary.<sup>419</sup> For legal, tax, and other reasons, advisers often use

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<sup>416</sup> Final rule 211(h)(1)-2(e)(2)(iii).

<sup>417</sup> See also Marketing Release, *supra* footnote 127, at n.61 (discussing clear and prominent disclosures in the context of advertisements).

<sup>418</sup> See, e.g., United for Respect Comment Letter I; Comment Letter of CPD Action (Apr. 25, 2022) ("CPD Comment Letter"); ICCR Comment Letter.

<sup>419</sup> See, e.g., Schulte Comment Letter; MFA Comment Letter I; Comment Letter of National Society of Compliance Professionals (Apr. 19, 2022) ("NSCP Comment Letter").

complex structures to set up private funds, which make it difficult, in certain circumstances, for advisers to calculate, and for investors to understand, fund performance as a whole. We recognize that, due to these complex structures, the criteria used and assumptions made in calculating performance can sometimes be nuanced and challenging to concisely include in the quarterly statement. Nonetheless, it is essential that advisers disclose assumptions, such as assumed fee rates, in the quarterly statement so that investors can readily understand the performance information being provided, despite these challenges. Without prominent disclosure of the criteria used and assumptions made in calculating performance, performance information is neither simple nor clear. Absent disclosure of the criteria used and assumptions made in the underlying calculations, performance information may not be simple to the extent it requires referencing multiple sources, such as capital call notices, distribution notices, and audited financials, to understand crucial criteria and assumptions. Such disclosure that is not prominent would also not be clear because it would obscure the extent and import of the adviser's assumptions or discretion in making such calculations.<sup>420</sup> To meet the prominence standard, the disclosures should, at a minimum, be readily noticeable and included within the quarterly statement. Thus, an adviser may not provide these disclosures only in a separate document, website hyperlink or QR code, or other separate disclosure.

We believe this prominently displayed information is vital in making these disclosures as simple and clear as possible for investors. Furthermore, permitting advisers to provide quarterly statements without prominent disclosure of the criteria used and assumptions made in calculating

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<sup>420</sup> One commenter suggested that private fund advisers should be required to provide supporting calculations to investors upon request. *See* CFA Comment Letter I. While advisers do not need to provide all supporting calculations as part of a quarterly statement, advisers generally should make them available upon request from an investor. While we believe it is important that investors have access to this information if requested, including all supporting calculations as a part of each quarterly statement could make each quarterly statement overly long and difficult to parse, thus undermining its utility.

performance would not sufficiently prevent practices that may be fraudulent, deceptive, or manipulative. For instance, advisers may use a deceptive assumed fee rate to calculate performance and investors may not be aware of it if it is not prominently disclosed in the quarterly statement. Accordingly, it is crucial that private fund investors receive this prominent disclosure as part of the quarterly statement itself.

### **3. Preparation and Distribution of Quarterly Statements**

The rule requires quarterly statements to be prepared and distributed to investors in private funds that are not funds of funds within 45 days after the first three fiscal quarter ends of each fiscal year and 90 days after the end of each fiscal year. Advisers to funds of funds must prepare and distribute quarterly statements within 75 days after the first three fiscal quarter ends of each year and 120 days after the fiscal year end.<sup>421</sup> In each instance, an adviser must prepare and distribute the required quarterly statement within the applicable period set forth in the rule, unless another person prepares and delivers such quarterly statement.<sup>422</sup> The reporting period for the final quarterly statement covers the fiscal quarter in which the fund is wound up and dissolved. Under the proposed rule, quarterly statements would have been required to be

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<sup>421</sup> In a change from the proposal, we are providing additional time for funds of funds to deliver quarterly statements in response to commenters that stated that many funds of funds will need to receive reporting from their private fund investments before they are able to prepare and distribute their own quarterly statements. For purposes of the final rule, one example of a fund of funds would be a private fund that invests substantially all of its assets in the equity of private funds that do not share its same adviser and, aside from such private fund investments, holds only cash and cash equivalents and instruments acquired to hedge currency exposure.

<sup>422</sup> By specifying that “such quarterly statement,” as opposed to more generally *a* quarterly statement, must be prepared and distributed, final rule 211(h)(1)-2 requires that a quarterly statement furnished by “another person” must still comply with paragraphs (a) through (g) of the rule, including with respect to the information otherwise required to be included in the quarterly statement by the investment adviser. For purposes of this section, to the extent that some but not all of the information that an investment adviser is required to include in the quarterly statement is included in a quarterly statement furnished by another person, the investment adviser generally would need to prepare and distribute separately the required information that is not included in the quarterly statement furnished by another person, as required under the final rule.

prepared and distributed to investors for each private fund, including funds of funds, within 45 days of each calendar quarter end, including after the end of the fiscal year.

For a newly formed private fund, the rule requires a quarterly statement to be prepared and distributed beginning after the fund's second full quarter of generating operating results, as proposed. However, one commenter stated that the requirement to provide performance metrics should not be triggered until the private fund has four quarters of operating results, rather than two.<sup>423</sup> We continue to believe, however, that two full quarters of operating results is an appropriate standard because it balances the needs of investors to receive performance information with the needs of advisers to have adequate time to generate results. We believe that the requirements for newly formed funds will help ensure that investors receive comprehensive information about the adviser's management of the fund during the early stage of the fund's life.

Some commenters supported the proposed rule's 45-day timing requirement.<sup>424</sup> Other commenters suggested that additional time or flexibility should be provided, as discussed below.<sup>425</sup> Based on our experience, advisers generally should be in a position to prepare and deliver quarterly statements within this period. We believe that the timing requirement is important because quarterly statements will provide fund investors with timely and regular statements that contain meaningful and comprehensive information. Some commenters, however, suggested allowing for additional time for the fourth quarterly statement of the year as audited financials are also being prepared at this time.<sup>426</sup> We recognize the value in providing

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<sup>423</sup> See AIC Comment Letter II.

<sup>424</sup> See, e.g., Convergence Comment Letter; Predistribution Initiative Comment Letter II; Healthy Markets Comment Letter I.

<sup>425</sup> See, e.g., MFA Comment Letter I; AIMA/ACC Comment Letter; Comment Letter of Ullico Investment Advisors, Inc. (Apr. 22, 2022) ("Ullico Comment Letter").

<sup>426</sup> See, e.g., ILPA Comment Letter I; SBAI Comment Letter; AIC Comment Letter I.



additional time for the fourth quarterly statement in light of the increased burdens that advisers will concurrently face in preparing other end-of-year statements, such as audited financials. Some commenters suggested specifically extending the deadline for the fourth quarterly statement to 120 days to parallel the deadline for audited financials.<sup>427</sup> Although we recognize the potential for some value in aligning the deadline for the fourth quarterly statement to 120 days to parallel the deadline for audited financials, it would delay the delivery of these quarterly statements too greatly. Assuming a December 31 fiscal year end, allowing 120 days would mean that an adviser would not have to deliver the fourth quarterly statement until April 30 of the following year (assuming it is not a leap year). However, the first quarterly statement for that following year would be due only 15 days later on May 15. It is important that investors receive quarterly statements on a timely basis so that they can effectively monitor the costs and performance of their investments. Additionally, requiring the preparation and delivery of the fourth quarterly statement before the deadline for audited financials under the final rule should not in our view lead to undue burdens or investor confusion. Although we recognize the possibility that information reported in the fourth quarterly statement may ultimately be updated or corrected in the subsequently delivered audited financials, the final rule will not separately require an adviser to issue a reconciled fourth quarterly statement reflecting such updated or corrected information (which, however, generally should be reflected in subsequent quarterly reports).<sup>428</sup> This approach balances the needs of investors to receive fee, expense, and

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<sup>427</sup> See, e.g., CFA Comment Letter I; AIC Comment Letter I.

<sup>428</sup> Although the rule does not separately require an adviser to issue to investors a reconciled fourth quarterly statement reflecting information updated or corrected in the subsequently delivered audited financials, advisers should consider whether particular updates or corrections to this information under the facts and circumstances could be sufficiently material to implicate other applicable disclosure obligations, e.g., as under rule 206(4)-8.

performance information relatively quickly following the end of the fiscal year, with the needs of advisers to have sufficient time to collect the necessary information and distribute the statements to investors. Accordingly, in response to commenters, we are increasing the deadline for the fourth quarterly statement from 45 days to 90 days. We believe that 90 days is an appropriate approach to allow additional time to prepare the fourth quarterly statement while also preparing the annual audited financials without delaying this quarterly statement too greatly.

Some commenters suggested allowing additional time for the first three quarterly statements of the year as well.<sup>429</sup> Other commenters suggested allowing for a more flexible standard, such as “as soon as reasonably practical” or “promptly”.<sup>430</sup> We do not think it is necessary to extend the time allowed for the first three quarterly statements or adopt a more flexible standard for the deadline. It is important that investors are receiving these quarterly statements routinely, so that they can properly monitor the fees and expenses and performance of their investments. If investors receive these quarterly statements only 60 or more days after quarter-end for the first three quarterly statements, the statements may be too delayed to enable effective engagement and investment decision-making as an investor (*e.g.*, whether to redeem from the private fund (if applicable), to invest additional amounts with or divest other investments with the adviser, or to otherwise modify the investor’s portfolio). Moreover, a more flexible standard, such as “as soon as reasonably practical” or “promptly,” might lead to inconsistently delivered quarterly statements, which could impair their comparability and thus their value. However, we recognize there may be times when an adviser reasonably believes that a fund’s quarterly statement would be distributed within the required timeframe but fails to have

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<sup>429</sup> See, *e.g.*, IAA Comment Letter II; Ropes & Gray Comment Letter; Comment Letter of Colmore (Apr. 25, 2022).

<sup>430</sup> See, *e.g.*, Ullico Comment Letter; Segal Marco Comment Letter; SBAI Comment Letter.

it distributed in time because of certain unforeseeable circumstances.<sup>431</sup> Accordingly, and in light of the fact that there is not an alternative method by which to satisfy the rule, the Commission 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, 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.

We asked in the proposal whether advisers should be required to report based on the private fund's fiscal periods, rather than calendar periods, as proposed. Because the proposed rule required advisers to distribute all four reports, including the fourth quarter report, within the same time period (*i.e.*, 45 days), we did not believe the distinction between fiscal periods and calendar periods was as significant for purposes of the proposed rule. However, because we are modifying the final rule to provide additional time for fourth quarter statements, as discussed above, we believe it is important to revisit this question. Because certain private funds may have a fiscal year that is different from the calendar year, we believe it is appropriate to revise the rule text to reference fiscal periods, rather than calendar periods, to ensure that advisers and private funds receive the benefit of the additional time for the fourth quarter statement. Commenters generally agreed with this approach, stating that fiscal periods would more closely align with industry practice.<sup>432</sup> We recognize that this modification may affect comparability for investors across different funds if their fiscal years differ, as funds with different fiscal years will have

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<sup>431</sup> For example, an adviser may experience sudden departures of senior financial employees.

<sup>432</sup> *See, e.g.*, AIMA/ACC Comment Letter; ILPA Comment Letter I; SIFMA-AMG Comment Letter I (suggesting that the SEC only require reporting on an annual basis within 120 days of the fund's fiscal year end); GPEVCA Comment Letter (suggesting that any periodic disclosure requirement be tied to the annual audit process).

different reporting periods. However, we view this potential disadvantage as being justified by the benefit investors will obtain by receiving quarterly statements that align with fund fiscal years. This modification will additionally allow funds with fiscal years that do not match the calendar year more time to prepare their fiscal year-end quarterly statements alongside their annual audited financials. It is also our understanding that the majority of private funds' fiscal years match the calendar year, and thus we do not expect comparability to be substantially affected in most cases. Accordingly, in a change from the proposal, advisers are required to distribute the required reporting based on a fund's fiscal periods, rather than calendar periods.

Some commenters suggested providing additional time for funds of funds because they would likely need to receive quarterly statements from their private fund investments before being able to prepare their own quarterly statements.<sup>433</sup> We recognize that some funds of funds, which generally invest substantially all of their assets in the equity of private funds advised by third-party advisers, will need to receive quarterly statements or other related information from their underlying investments to prepare their own quarterly statements. We also recognize that such underlying investments may not provide the quarterly statements until the last day of the deadline. Accordingly, we are providing an additional 30 days for funds of funds to deliver each quarterly statement and, as such, only requiring funds of funds to distribute the first three quarterly statements of the year within 75 days after quarter end and the fourth quarterly statement within 120 days after quarter end. We believe this approach strikes an appropriate balance between granting fund of funds advisers additional time to prepare and deliver quarterly

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<sup>433</sup> See, e.g., ILPA Comment Letter I (suggesting additional time of 14 days to prevent the routine use of stale data); MFA Comment Letter I (suggesting additional time of 30 days); Comment Letter of Pathway Capital Management, LP (June 13, 2022) ("Pathway Comment Letter") (suggesting that funds of funds advisers will rely on reports from underlying investments and require additional time); CFA Comment Letter II (suggesting a deadline of 120 days for the first three quarterly statements and 180 days for the fourth quarterly statement).

statements and not overly delaying such quarterly statements for fund of funds and other private fund investors. Advisers to funds (including funds of funds and, similarly, funds of funds of funds)<sup>434</sup> that do not currently receive information from their underlying investments in a sufficiently timely manner to enable them to prepare and deliver quarterly statements in compliance with the final rule’s deadlines will need to consider contractual or other types of arrangements with their underlying investments to attain this information in a timely manner.

An adviser generally will satisfy the requirement to “distribute” the quarterly statements when the statements are sent to all investors in the private fund.<sup>435</sup> However, the rule 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 (*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

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<sup>434</sup> Some commenters suggested that we provide further additional time to funds of funds of funds, similar to staff views provided with respect to the audit provision of the custody rule, to permit these funds additional time to receive information from their underlying investments. *See, e.g.*, CFA Comment Letter II. The Commission is not extending further additional time for quarterly statements with respect to funds of funds of funds, as doing so would delay the provision of quarterly statement information to investors too significantly, as discussed above.

<sup>435</sup> *See* final rule 211(h)(1)-1 (defining “distribute”). For purposes of the rules, any “in writing” requirement can be satisfied either through paper or electronic means consistent with existing Commission guidance on electronic delivery of documents. *See* Marketing Release, *supra* footnote 127, at n.346. If any distribution is made electronically for purposes of these rules, it should be done in accordance with the Commission’s guidance regarding electronic delivery. *See* Use of Electronic Media by Broker Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940, Release No. 34-37182 (May 9, 1996) [61 FR 24644 (May 15, 1996)] (“Use of Electronic Media Release”); *see also* Commission Interpretation: Use of Electronic Media, Release No. 34-42728 (Apr. 28, 2020) [65 FR 25843 (May 4, 2000)]. In circumstances where an adviser is obligated to rely on a third party, such as a trustee, to deliver quarterly statements to investors, an adviser should use every reasonable effort to effect such delivery in compliance with the final rule.

investors in those pools. Additionally, advisers to private funds may from time to time establish special purpose vehicles (“SPVs”) or other pooled vehicles for a variety of reasons, including facilitating investments by one or more private funds that the advisers manage. Without such a control relationship requirement, the adviser could deliver the quarterly statement to itself rather than to the parties the quarterly statement is designed to inform.<sup>436</sup> 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 meaningful delivery of the quarterly statement. The adviser should distribute the quarterly statement to the adviser or other designated party of the unaffiliated fund of funds. We believe that this approach will lead to meaningful delivery of the quarterly statement to the private fund’s investors.

Some commenters suggested allowing distribution via a data room instead of requiring delivery to investors.<sup>437</sup> It is important that advisers are effectively delivering quarterly statements to investors on a routine basis. If a quarterly statement is distributed electronically through a data room, this distribution, like other electronic deliveries, should be done in accordance with the Commission’s guidance regarding electronic delivery.<sup>438</sup> Accordingly, if an adviser places the quarterly statements in a data room without any notice to investors, advisers would not meet the distribution requirement under the rule. However, if the 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

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<sup>436</sup> See final rule 211(h)(1)-1 (defining “control”).

<sup>437</sup> See, e.g., Ropes & Gray Comment Letter; AIMA/ACC Comment Letter; AIC Comment Letter II.

<sup>438</sup> See Use of Electronic Media Release, *supra* footnote 435.

investors have access to the quarterly statement included therein, an adviser would generally satisfy the distribution requirement.<sup>439</sup>

#### **4. Consolidated Reporting for Certain Fund Structures**

The rule requires advisers to consolidate reporting for similar pools of assets to the extent doing so provides more meaningful information to the private fund's investors and is not misleading, as proposed.<sup>440</sup> For example, certain private funds employ master-feeder structures. Typically, investors in such funds invest in onshore and offshore feeder funds, which, in turn, invest all, or substantially all, of their investable capital in a single master fund. The same adviser typically advises and controls all three funds, and the master fund typically makes and holds the investments. Because the feeder funds are conduits for investors to gain exposure to the master fund and its investments, the rule requires the adviser to provide feeder fund investors with a single quarterly statement covering the applicable feeder fund and the feeder fund's proportionate interest in the master fund on a consolidated basis, so long as the consolidated statement provides more meaningful information to investors and is not misleading.

Due to the complexity of private fund structures, the rule takes a principles-based approach with respect to whether private fund advisers must consolidate reporting for a specific fund structure.

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<sup>439</sup> See *id.*

<sup>440</sup> See final rule 211(h)(1)-2(f). The use of any consolidated reporting is an important criterion for the calculation of expenses, payments, allocations, rebates, waivers, and offsets as well as performance. See *supra* sections II.B.1.c) and II.B.2.c). Accordingly, advisers generally should disclose the basis of any consolidated reporting in the quarterly statement, including, *e.g.*, if the statement includes multiple entities and, if so, which entities and the methods used to calculate the amounts on the statement allocated from each entity. Advisers generally should also disclose any important assumptions associated with consolidated reporting that affect performance reporting as part of the quarterly statement. An example might include how unequal tax expenses are factored into consolidated performance reporting where one fund has greater tax expenses than the other funds in a consolidated fund structure. See *supra* section II.B.2.c).

Some commenters supported this principles-based approach to consolidated reporting for certain fund structures, arguing that it will provide more meaningful information to investors.<sup>441</sup> Other commenters argued that this consolidation requirement could undermine the transparency goals of this rulemaking.<sup>442</sup> Some commenters argued that consolidated reporting will confuse investors.<sup>443</sup>

We acknowledge that, in certain circumstances, requiring reporting by each private fund separately may result in more granular information. For example, in certain parallel fund structures, an investor would receive information specific to the parallel fund in which it is invested instead of the consolidated information for all parallel funds. However, in many of these circumstances, consolidated reporting of the cost and performance information by all private funds in the structure would provide a more comprehensive picture of the fees and expenses borne and performance achieved than reporting by each private fund separately. For instance, in a master-feeder fund structure, a quarterly statement that only covers the feeder fund could provide fragmented information that does not reflect the true costs and performance relevant to a feeder fund investor. For example, a feeder fund's returns may be significantly impacted by costs at the master fund-level, but unconsolidated quarterly statements would mean these costs would not necessarily appear in the feeder fund's quarterly statement. Additionally, absent a principles-based consolidation requirement, advisers may be incentivized to establish as many feeder or parallel funds in a particular fund structure as feasible to separate investors.

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<sup>441</sup> See, e.g., GPEVCA Comment Letter; Convergence Comment Letter; CFA Comment Letter II.

<sup>442</sup> See, e.g., SIFMA-AMG Comment Letter I; SBAI Comment Letter; Ropes & Gray Comment Letter (describing, as an example, certain master-feeder fund structures where some of the feeder funds do not invest in the master fund).

<sup>443</sup> See, e.g., Ropes & Gray Comment Letter; PWC Comment Letter (the consolidation requirement could create confusion in instances where U.S. GAAP does not require consolidation for financial reporting purposes); IAA Comment Letter II.



Investors may then each be receiving different fee, expense, and performance information, which could make it difficult for them to communicate and address collective concerns with the adviser. For these reasons, we believe that a principles-based approach to consolidated reporting is superior to a requirement to report by each private fund separately.

Similarly, the absence of any consolidation requirement could lead to differing practices across advisers and result in greater investor confusion. Some advisers could choose to consolidate all fund structures, while others choose to do no consolidation, and still others choose to consolidate some fund structures—such as parallel funds—but not others—such as master-feeder arrangements. Investors with minimal negotiating power may have a difficult time obtaining accurate information on an adviser’s approach to consolidation or requiring that an adviser take a consistent approach if the fund structure is expanded over the course of its life. By requiring a similar, principles-based approach to all fund structures, we believe the quarterly statement will be generally easier for investors to understand across advisers.

Some commenters suggested that we should provide additional specific clarification on when consolidated reporting is and is not required.<sup>444</sup> While we recognize that a principles-based approach to consolidated reporting may require some additional consideration on the part of advisers, an overly prescriptive consolidation requirement would have a greater negative effect. The private fund space is diverse. There are many different fund structures, and it is reasonable to expect that more will be devised in the future. We understand that different segments of the private fund adviser industry tend to use some fund structures more than others and, correspondingly, tend to have different views on what kinds of related funds should be considered similar pools of assets for purposes of consolidation. The rule’s principles-based

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<sup>444</sup> See, e.g., KPMG Comment Letter; LSTA Comment Letter; AIMA/ACC Comment Letter.

approach to consolidated reporting is designed to reflect this diversity by requiring advisers to consolidate when doing so will provide more meaningful information. We recognize that this may lead to some degree of difference across different segments of the private fund adviser industry, but it will ultimately result in more meaningful information for investors. Relatedly, private fund advisers generally should take into account any input received from investors on what approach to consolidation that they view as most meaningful.

## **5. Format and Content Requirements**

As proposed, the rule requires the adviser to use clear, concise, plain English in the quarterly statement.<sup>445</sup> For example, to satisfy the requirement for “clear” disclosures, advisers should generally use a font size and type that are legible, and margins and paper size (if applicable) that are reasonable. Likewise, to meet this standard, any information that an adviser chooses to include in a quarterly statement, but is not required by the rule, must be as short as practicable, not more prominent than the required information, and not obscure or impede an investor’s understanding of the mandatory information. The rule also requires advisers to present information in the quarterly statement in a format that facilitates review from one quarterly statement to the next. Quarter-over-quarter, an adviser generally should use consistent formats for fund quarterly statements, thereby allowing investors to easily compare fees, expenses, and performance over each quarterly period. We also encourage advisers to use a structured, machine-readable format if advisers believe this format will be useful to the investors in their funds.

Some commenters supported this format and content requirement, stating that consistent formatting for quarterly statements will better enable investors to gauge adviser track records and

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<sup>445</sup> Final rule 211(h)(1)-2(g).

appropriateness of costs.<sup>446</sup> Some commenters argued that we should adopt *more* prescriptive formatting requirements.<sup>447</sup> Conversely, certain commenters argued that we should not adopt prescriptive formatting requirements.<sup>448</sup> Other commenters suggested that these format and content requirements are not necessary because investors may already negotiate for specific format and content requirements for investor reporting.<sup>449</sup>

Although some investors may be able to negotiate for bespoke content and formatting for investor reporting, many investors may not have the bargaining power to do so. A goal of the quarterly statement requirement is to better enable all investors to effectively monitor and assess the costs and performance of their private fund investments with an investment adviser over time. The format and content requirements apply to all aspects of a quarterly statement, including the requirements to disclose the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated and to cross-reference sections of the private fund’s organizational and offering documents.<sup>450</sup> This approach will improve the utility of the quarterly statement by making it easier for investors to review and analyze.

These requirements are intended to support every investor’s ability to understand better the context of the information provided in the quarterly statement regarding fees, expenses, and performance and monitor their private fund investments. For instance, providing investors with clear and easily accessible cross-references to the fund governing documents will make it easier

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<sup>446</sup> See, e.g., CFA Comment Letter II; NYSIF Comment Letter; Consumer Federation of America Comment Letter.

<sup>447</sup> See, e.g., Morningstar Comment Letter; Albourne Comment Letter.

<sup>448</sup> See, e.g., SBAI Comment Letter; AIMA/ACC Comment Letter; Comment Letter of the Private Investment Funds Committee of the State Bar of Texas Business Law Section (Apr. 25, 2022) (“State Bar of Texas Comment Letter”).

<sup>449</sup> See, e.g., AIC Comment Letter I; Comment Letter of the American Securities Association (May 4, 2022) (“ASA Comment Letter”); State Bar of Texas Comment Letter.

<sup>450</sup> Final rule 211(h)(1)-2(d).

for all investors to assess and monitor whether the fees and expenses in the quarterly statement comply with the fund's governing documents.

We believe the final rule strikes an appropriate balance in prescribing the baseline content of the tables and performance information that is required to be included in quarterly statements while also taking a generally principles-based approach with respect to the formatting of such information. This approach will help provide investors with standardized baseline information about their private fund investments and advisers with flexibility in presenting the required information, without being overly prescriptive or sacrificing readability. Additionally, as stated above, advisers under the rule remain able to provide, and investors are free to request and negotiate for, additional information to supplement the required information in the quarterly statement, subject to applicable rules and other disclosure requirements.

We are requiring a tabular format to ensure the information in the quarterly statements is presented in an organized fashion, but we view further prescriptive formatting as potentially more harmful than beneficial in many cases. We considered, but are not adopting, more prescriptive formatting because we recognize it might result in investor confusion if an adviser includes inapplicable line items to satisfy our form requirements, while omitting additional relevant information that might be unique to a particular fund. The private fund space is diverse, and specific reporting formats could be appropriate for certain types of funds but inappropriate for different types of funds. For instance, the fees and expenses associated with a private equity buyout fund will differ from those for a private credit fund.<sup>451</sup> If we were to prescribe formatting

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<sup>451</sup> We would generally anticipate the fee and expense line items of a private credit fund to be more associated with loans or other financing activities, and servicing activity related thereto, and the fee and expense line items of a private equity buyout fund to be more associated with the acquisitions and dispositions of portfolio companies.

that is effective for a buyout fund, such formatting may be misleading or confusing when applied to a private credit fund, a real estate fund or a hedge fund. Moreover, we were concerned that advisers would be unable to report on a consolidated basis if we further prescribed the format of the statements.

## **6. Recordkeeping for Quarterly Statements**

We are amending rule 204-2 (“books and records rule”) under the Advisers Act to require advisers to retain books and records related to the quarterly statement rule.<sup>452</sup> First, we are requiring private fund advisers to make and retain a copy 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.<sup>453</sup> Second, we are requiring advisers to make and retain 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. Third, we are requiring advisers to make and keep 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.<sup>454</sup> These requirements will facilitate our staff’s

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<sup>452</sup> Final amended rule 204-2(a)(20). For all of the recordkeeping rule amendments in this rulemaking package, advisers are required to maintain and preserve the record in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser. *See* rule 204-2(e)(1) under the Advisers Act.

<sup>453</sup> We asked in the proposal whether we should require advisers to retain a record of each addressee, the date(s) the statement was sent, address(es), and delivery method(s) for each quarterly statement, as proposed. In response to comments received and in a change from the proposal (as discussed further below in this section), we are not requiring private fund advisers to make and retain records of addresses or the delivery methods used to disseminate quarterly statements. If an adviser distributes a quarterly statement electronically through a data room (*see* discussion of data rooms in *supra* section II.B.3), 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.

<sup>454</sup> In certain circumstances, an adviser may change its determination of whether a particular fund it advises is a liquid or illiquid fund pursuant to the quarterly statement rule. For example, an adviser may determine a

ability to assess an adviser's compliance with the proposed rule and would similarly enhance an adviser's compliance efforts.

Some commenters supported this recordkeeping requirement<sup>455</sup> including one that stated that it would not be overly burdensome for advisers.<sup>456</sup> Other commenters argued that this recordkeeping requirement will be burdensome and/or not beneficial for investors.<sup>457</sup> We do not view this recordkeeping requirement as creating significant, additional burdens. As a practical matter, advisers will need to generate these records to comply with the quarterly statement rule, and we anticipate that they would only need to modify their existing recordkeeping procedures to properly maintain these records as well. Requiring recordkeeping for quarterly statements should also enhance advisers' internal compliance efforts. Moreover, this recordkeeping will help facilitate the Commission's inspection and enforcement capabilities by improving our staff's ability to assess an adviser's compliance with the final rule.

One commenter suggested that, instead of requiring, for each quarterly statement, recordkeeping of each addressee, the date(s) sent, address(es) and delivery method(s), we should require only records necessary to demonstrate compliance with the quarterly statement distribution requirement.<sup>458</sup> We agree that the addresses and delivery methods used to disseminate quarterly statements are not necessary to demonstrate compliance with the quarterly statement distribution requirement and have removed those obligations accordingly. However,

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fund it advises is a liquid fund in year one and then later determine it is an illiquid fund in year four because the nature of such fund's redemption rights have changed. In such cases, advisers should also make and keep books and records substantiating the adviser's determination of such change.

<sup>455</sup> See, e.g., Convergence Comment Letter; AFREF Comment Letter I; CPD Comment Letter.

<sup>456</sup> See Convergence Comment Letter.

<sup>457</sup> See, e.g., ATR Comment Letter; Chamber of Commerce Comment Letter; AIMA/ACC Comment Letter.

<sup>458</sup> See CFA Comment Letter II.

we believe that recordkeeping of each addressee and the dates sent are necessary to demonstrate compliance with the final rule. Records of the distribution dates will demonstrate compliance with the various distribution deadlines set forth in the final rule. Records of the addressees are similarly necessary to demonstrate that each quarterly statement has been sent to each investor. These recordkeeping requirements will permit Commission staff to effectively assess an adviser's compliance with the rule.

### **C. Mandatory Private Fund Adviser Audits**

We are requiring private fund advisers to obtain an annual financial statement audit of the private funds they advise, directly or indirectly.<sup>459</sup> In addition to protecting the fund and its investors against the misappropriation of fund assets, we believe an audit by an independent public accountant provides an important check on the adviser's valuation of private fund assets, which often serves as the basis for the calculation of the adviser's fees. It also provides an important check on certain conflicts of interest between the adviser and the private fund investors, such as potentially problematic sales practices or compensation schemes. For example, during a financial statement audit, an auditor will inquire about related party relationships and transactions, including the identity of any related parties, the nature of the relationships, and the business purpose of entering into any transaction with a related party.<sup>460</sup> Moreover, as part of the auditor's substantive testing, an auditor may review the calculation and presentation of management fees paid to the adviser and may focus on capital allocations to review the adviser's entitlement to performance-based compensation. While the auditor does not

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<sup>459</sup> Final rule 206(4)-10. The rule would apply to all investment advisers registered, or required to be registered, with the Commission.

<sup>460</sup> See American Institute of Certified Public Accountants' ("AICPA") auditing standards, AU-C Section 550 and PCAOB auditing standards, AS 2410.

have primary responsibility to prevent and detect fraud, it does have a responsibility to obtain reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.<sup>461</sup>

We are adopting the substance of the mandatory private fund adviser audit rule largely as proposed. The proposed rule was primarily drawn from the Advisers Act custody rule but differed from that rule in several respects.<sup>462</sup> Commenters explained that these differences could create confusion with, and be duplicative of, the custody rule.<sup>463</sup> For example, commenters stated that a staff guidance update on the application to SPVs would apply under the custody rule but not here.<sup>464</sup> Similarly, other commenters stated that staff guidance issued in frequently asked questions would apply under the custody rule but not here.<sup>465</sup> One commenter asserted that the imposition of overlapping and inconsistent standards between the requirements of the custody rule and this rule would not serve to increase investor protection.<sup>466</sup> After considering comments, we are adopting a final rule that addresses those differences. More specifically, we are requiring advisers registered with, or required to be registered with, the Commission to cause

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<sup>461</sup> See AICPA auditing standards, AU-C Section 240. Audits performed under PCAOB standards provide similar benefits. See PCAOB auditing standards, AS 2401, which discusses consideration of fraud in a financial statement audit.

<sup>462</sup> See Proposing Release, *supra* footnote 3, at 101-103.

<sup>463</sup> See IAA Comment Letter II; NYC Bar Comment Letter II; AIC Comment Letter I.

<sup>464</sup> See Comment Letter of Ernst & Young (Apr. 25, 2022) (“E&Y Comment Letter”); Comment Letter of Deloitte & Touche LLP (Apr. 21, 2022) (“Deloitte Comment Letter”); KPMG Comment Letter; PWC Comment Letter; AIC Comment Letter I; TIAA Comment Letter; NSCP Comment Letter. See also Private Funds and Application of the Custody Rule to Special Purpose Vehicles and Escrows, Division of Investment Management Guidance Update No. 2014-07 (June 2014).

<sup>465</sup> See SIFMA-AMG Comment Letter I. See also Staff Responses to Questions about the Custody Rule (“Custody Rule FAQs”), available at [https://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](https://www.sec.gov/divisions/investment/custody_faq_030510.htm).

<sup>466</sup> See NYC Bar Comment Letter II.



their private funds to undergo audits in accordance with the audit provision (and related requirements for delivery of audited financial statements) under the custody rule.<sup>467</sup>

The mandatory private fund adviser audit rule requires a registered investment adviser providing investment advice, directly or indirectly, to a private fund, to cause that fund to undergo a financial statement audit that meets the requirements set forth in paragraphs (b)(4)(i) through (b)(4)(iii) of the custody rule applicable to pooled investment vehicles subject to annual audit and to cause audited financial statements to be delivered in accordance with paragraph (c) of that rule. As a result, each of the following is required under the final rule:

(1) The audit must be performed by an independent public accountant that meets the standards of independence in 17 CFR 210.2-01 (rule 2-01(b) and (c) of Regulation S-X) that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the PCAOB in accordance with its rules;<sup>468</sup>

(2) The audit must meet the definition of audit in 17 CFR 210.1-02(d) (rule 1-02(d) of Regulation S-X);<sup>469</sup>

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<sup>467</sup> Rule 206(4)-2(b)(4) and (c). In a change from the proposal, defined terms in rule 206(4)-10 are as defined in the custody rule; they are not defined in rule 211(h)-1. *See* rule 206(4)-10(c). The SEC has proposed to amend and redesignate the custody rule. *See* Safeguarding Advisory Client Assets, Investment Advisers Act Release No. 6240 (Feb. 15, 2023) [88 FR 14672 (Mar. 9, 2023)] (“Safeguarding Release”). We are continuing to consider comments received in response to that proposal.

<sup>468</sup> *See* rule 206(4)-2(b)(4)(ii) and 206(4)-2(d)(3) (defining “independent public accountant”).

<sup>469</sup> *See* rule 206(4)-2(b)(4). The custody rule requires an accountant performing an audit of a pooled investment vehicle to be an “independent public accountant” complying with rule 2-01(b) and (c) of Regulation S-X. Rule 2-01(c) of Regulation S-X references the term “audit and professional engagement period,” which is defined in rule 2-01(f)(5) of Regulation S-X.

(3) Audited financial statements must be prepared in accordance with generally accepted accounting principles;<sup>470</sup> and

(4) Annually within 120 days of the private fund’s fiscal year-end and promptly upon liquidation, the private fund’s audited financial statements are delivered to investors in the private fund.<sup>471</sup>

Additionally, in recognition that a surprise examination under the custody rule does not satisfy the requirements of this rule, we are adopting the proposed exception to this rule for funds and advisers not in a control relationship. Specifically, for a fund that the adviser does not control and that is neither controlled by nor under common control with the adviser (*e.g.*, an adviser to a fund of funds may select an unaffiliated sub-adviser to implement a portion of the underlying investment strategy), the adviser only needs to take all reasonable steps to cause the fund to undergo an audit that meets these elements.<sup>472</sup>

Some commenters supported the proposed rule,<sup>473</sup> while others opposed it<sup>474</sup> and one commenter highlighted the importance of the proposed notification provision explaining that the

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<sup>470</sup> The SEC has stated that certain financial statements must either be prepared in accordance with U.S. GAAP or prepared in accordance with some other comprehensive body of accounting standards if the information is substantially similar to financial statements prepared in accordance with U.S. GAAP and contain a footnote reconciling any material differences. *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003) [68 FR 56691 (Oct. 1, 2003)] (“2003 Custody Rule Release”) at n.41. Our staff has taken a similar view. *See* Custody Rule FAQs, *supra* footnote 465, at Question VI.5.

<sup>471</sup> *See* rule 206(4)-2(b)(4) and (c).

<sup>472</sup> *See* final rule 206(4)-10(b).

<sup>473</sup> *See* Public Citizen Comment Letter; Healthy Markets Comment Letter I; Trine Comment Letter; AFREF Comment Letter I; OPERS Comment Letter; ICM Comment Letter; NASAA Comment Letter; Better Markets Comment Letter; Albourne Comment Letter; ILPA Comment Letter I; Segal Marco Comment Letter; RFG Comment Letter II; Convergence Comment Letter; NCREIF Comment Letter.

<sup>474</sup> *See* PIFF Comment Letter; BVCA Comment Letter; Invest Europe Comment Letter; AIC Comment Letter I; Comment Letter of Steven Utke and Paul Mason (Feb. 26, 2022) (“Utke and Mason Comment Letter”); Dechert Comment Letter; AIMA/ACC Comment Letter; Comment Letter of Canaras Capital Management LLC (Apr. 25, 2022) (“Canaras Comment Letter”); SBAI Comment Letter; Ropes & Gray Comment Letter; IAA Comment Letter II; NYC Bar Comment Letter II.

issuance of a modified opinion or the auditor’s termination may be “serious red flags that warrant early notice to regulators.”<sup>475</sup> Commenters who opposed the proposed rule indicated that it: (i) would eliminate the surprise examination option under the custody rule without evidence that surprise examinations have not adequately protected private fund investors;<sup>476</sup> (ii) might increase costs to investors and be unnecessary;<sup>477</sup> (iii) would not serve the stated policy goals of acting as a check on the adviser’s valuation of private fund assets;<sup>478</sup> (iv) may provide investors a false sense of security;<sup>479</sup> and (v) could increase the difficulty of finding an auditor in certain jurisdictions.<sup>480</sup>

While the mandatory private fund adviser audit rule would effectively eliminate the surprise examination option under the custody rule for private fund advisers and may increase costs to some investors, we believe that financial statement audits provide a critical set of additional protections for private fund investors. During a financial statement audit, independent public accountants not only typically verify the existence of pooled investment vehicle investments similar to a surprise examination, but they also test other assertions associated with the pooled investment vehicle investments and other significant accounts (*e.g.*, valuation, presentation and disclosure, rights and obligations, completeness, and accuracy). Importantly, audited financial statements, including the related notes, schedules, and audit opinion, must be

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<sup>475</sup> See NASAA Comment Letter.

<sup>476</sup> See AIMA/ACC Comment Letter.

<sup>477</sup> See PIFF Comment Letter; BVCA Comment Letter; Invest Europe Comment Letter; Utke and Mason Comment Letter; Dechert Comment Letter; AIMA/ACC Comment Letter.

<sup>478</sup> See AIC Comment Letter I; BVCA Comment Letter.

<sup>479</sup> See Chamber of Commerce Comment Letter.

<sup>480</sup> See SBAI Comment Letter; AIMA/ACC Comment Letter; Comment Letter of LaSalle Investment Management, Inc. (Apr. 25, 2022) (“LaSalle Comment Letter”); CFA Comment Letter I; PWC Comment Letter; Ropes & Gray Comment Letter.

distributed to each investor in the pooled investment vehicle, providing investors with additional information about the operation of the private fund.<sup>481</sup> For example, audited financial statements prepared in accordance with U.S. GAAP, which are the responsibility of the private fund adviser or its related person, include disclosures regarding the level of fair value hierarchy within which the fair value measurements are categorized in their entirety and a description of the valuation techniques and inputs used in the fair value measurement of the fund's investments.<sup>482</sup> These audited financial statements also include disclosures regarding material related party transactions.<sup>483</sup> In addition, fund borrowings, such as margin borrowings or fund-level subscription facilities, are disclosed in the financial statements.<sup>484</sup> These are just a few examples of the types of critical information provided to investors in audited financial statements to help them better understand the private fund's operations and financial position. If, in lieu of audited financial statements, an investment adviser obtains a surprise examination of the funds and securities of its client (*e.g.*, a private fund), an investor may not receive this additional important information. Comments from institutional investors generally acknowledged the benefits of annual financial statement audits as providing an important tool for monitoring their investments.<sup>485</sup> These commenters explained that audits enhance investor protection<sup>486</sup> and the mandatory private fund adviser audit rule would introduce a degree of consistency across private

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<sup>481</sup> Final rule 206(4)-10; *see also* rule 206(4)-2(b)(4) and rule 206(4)-2(c).

<sup>482</sup> FASB ASC Topic 820, *Fair Value Measurement*.

<sup>483</sup> FASB ASC Topic 850, *Related Party Disclosures*.

<sup>484</sup> FASB ASC Topic 470, *Debt* and FASB ASC Subtopic 860-30, *Secured Borrowing and Collateral*.

<sup>485</sup> *See* OPERS Comment Letter; AFSCME Comment Letter; ILPA Comment Letter I; NYC Comptroller Comment Letter; *see generally* Seattle Retirement System Comment Letter; DC Retirement Board Comment Letter.

<sup>486</sup> NYC Comptroller Comment Letter.

funds.<sup>487</sup> One commenter stated that audits are critical to protecting the fund's assets from fraud and malfeasance,<sup>488</sup> while another commenter explained that annual audits provide investors more accurate valuations, which also often serve as the basis for calculation of fees.<sup>489</sup> Accordingly, we continue to believe the benefits of a financial statement audit to private fund investors justify the elimination of the surprise examination option for private fund advisers and the associated costs.

We disagree with commenters' assertions that the audit requirement will not serve the stated policy goals of acting as a check on the adviser's valuation of private fund assets.<sup>490</sup> Financial statement audits provide meaningful protections to private fund investors by increasing the likelihood that fraudulent activity or problems with valuation are uncovered, thereby providing deterrence against fraudulent conduct by fund advisers or their related persons.<sup>491</sup> For example, as noted above, a fund's adviser may use a high level of discretion and subjectivity in valuing a private fund's illiquid investments, which are difficult to value. This creates a conflict of interest if the adviser also calculates its fees as a percentage of the value of the fund's investments and/or an increase in that value (net profit), as is typically the case. Moreover, private fund advisers often rely heavily on existing fund performance when engaging in sales practices: obtaining new investors (in the case of a private fund that makes continuous or periodic offerings), retaining existing investors (in the case of a private fund that offers periodic redemptions or transfer rights), soliciting investors for co-investment opportunities, or

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<sup>487</sup> See OPERS Comment Letter.

<sup>488</sup> See ILPA Comment Letter I.

<sup>489</sup> See AFSCME Comment Letter.

<sup>490</sup> See AIC Comment Letter I; BVCA Comment Letter.

<sup>491</sup> See AICPA auditing standards, AU-C Section 240 and PCAOB auditing standards, AS 2401.

fundraising for a new fund. These factors raise the possibility that funds are valued opportunistically and that the adviser's compensation may involve fraud or deception, resulting in an inappropriate compensation scheme.<sup>492</sup> A fund audit includes the evaluation of whether the fair value estimates and related disclosures are in conformity with the requirements of the financial reporting framework (e.g., U.S. GAAP), which may include evaluating the selection and application of methods, significant assumptions, and data used by the adviser in making the estimate.<sup>493</sup> The Commission continues to believe that private fund audits are an important tool to provide a check on private fund valuations.

One commenter expressed concerns that private equity fund audits are unnecessary because “[p]rivate equity funds typically charge management fees based on capital commitments, or sometimes invested capital, neither of which is affected by subjective valuation methods.”<sup>494</sup> We, however, have observed instances of advisers to private equity funds overcharging their management fee by failing to write down the value of fund investments.<sup>495</sup> In these cases, the subjective valuation method is particularly important because the adviser may

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<sup>492</sup> See generally Jenkinson, Sousa, Stucke, *How Fair are the Valuations of Private Equity Funds?* (2013), available at <https://www.psers.pa.gov/About/Investment/Documents/PPMAIRC%202018/27%20How%20Fair%20are%20the%20Valuations%20of%20Private%20Equity%20Funds.pdf>. See also *In the Matter of Swapnil Rege*, Investment Advisers Act Release No. 5303 (July 18, 2019) (settled action) (alleging that an employee of a private fund adviser mispriced the private fund's investments, which resulted in the adviser charging the fund excess management fees); *SEC v. Southridge Capital Mgmt., LLC*, Lit. Rel. No. 21709 (Oct. 25, 2010) (alleging that adviser overvalued the largest position held by the funds by fraudulently misstating the acquisition price of the assets); see docket for *SEC v. Southridge Capital Mgmt., LLC*, U.S. District Court, District of Connecticut (New Haven), case no. 3:10-CV-01685 (on Sept. 12, 2016 the court granted the SEC's motion for summary judgment and entered a final judgment in favor of the SEC in 2018).

<sup>493</sup> See AICPA auditing standards AU-C Section 540A and PCAOB auditing standards, AS 2501.

<sup>494</sup> See AIC Comment Letter I.

<sup>495</sup> See *In the Matter of EDG Management Company, LLC*, *supra* footnote 30; see also *In the Matter of Energy Capital Partners*, *supra* footnote 30; *Innovation Capital Management, LLC*, Investment Advisers Act Release No. 6104 (Sept. 2, 2022) (settled order).

have to decrease invested capital by any permanent impairments or write-downs of portfolio investments in accordance with the fund documents, which, in turn, decreases the management fee paid to the adviser. Also, during an annual period in which a private equity fund has sold a portfolio investment, the auditor typically reviews the fund's waterfall calculation including the calculations for return of invested capital, return of allocable expenses, the preferred return, the general partner catch-up, if applicable, and any incentive allocation, as part of the annual audit. Thus, the Commission continues to believe that the mandatory audit requirement should apply to private fund advisers, including advisers to private equity funds.

One commenter expressed concern that the mandatory audit requirement may give investors a false sense of security because the PCAOB does not have the authority to inspect audit engagements that involve private fund financial statements.<sup>496</sup> Under the PCAOB's current inspection program, we understand that the PCAOB selects audit engagements of audits performed involving U.S. public companies, other issuers, and broker-dealers, so private fund audit engagements would not be selected for review.<sup>497</sup> Even though private fund engagements are not selected for review under the PCAOB's current inspection program, we believe that many accounting firms registered with the PCAOB and subject to the PCAOB's inspection program would implement their quality control systems throughout the accounting firm related to all their assurance engagements. Thus, we continue to believe that registration and regular inspection of an independent public accountant's system of quality control by the PCAOB may provide higher quality audits, resulting in additional investor protection.

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<sup>496</sup> See Chamber of Commerce Comment Letter.

<sup>497</sup> Public Company Accounting Oversight Board, *Basics of Inspections, Inspections: An Overview* (last visited Aug. 13, 2023), available at <https://pcaobus.org/oversight/inspections/basics-of-inspections>.

Commenters also expressed concerns that advisers may have increased difficulty finding an auditor in certain jurisdictions because requiring independent public accountants conducting the audit to be registered with, and subject to inspection by, the PCAOB would greatly limit the pool of accountants available to conduct audits.<sup>498</sup> As noted above, we do not apply substantive provisions of the Advisers Act and its rules, including the mandatory audit requirement, with respect to non-U.S. clients (including private funds) of an SEC registered offshore investment adviser.<sup>499</sup> We believe that this clarification will reduce many of the concerns expressed by commenters regarding the difficulty for non-U.S. private fund advisers finding an auditor in certain jurisdictions.

In addition, we do not believe that advisers will have significant difficulty in finding an accountant that is eligible under the rule in most jurisdictions because many PCAOB-registered independent public accountants who are subject to regular inspection currently have practices in various jurisdictions, which may ease concerns regarding offshore availability. An independent public accounting firm would not, however, be considered to be “subject to regular inspection” if it is included on the list of firms that is headquartered or has an office in a foreign jurisdiction that the PCAOB has determined, in accordance with PCAOB Rule 6100, it is unable to inspect or investigate completely because of a position taken by one or more authorities in that jurisdiction.<sup>500</sup> Based on our experience with the custody rule, we believe registration and the regular inspection of an independent public accountant’s system of quality control by the PCAOB may lead to higher quality audits, resulting in additional investor protection. Further,

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<sup>498</sup> See AIMA/ACC Comment Letter; AIC Comment Letter I.

<sup>499</sup> See, e.g., Exemptions Adopting Release, *supra* footnote 9.

<sup>500</sup> See, e.g., PCAOB Reports of Board Determinations Pursuant to Rule 6100, *available at* <https://pcaobus.org/oversight/international/board-determinations-holding-foreign-companies-accountable-act-hfcaa>.



most private funds are already undergoing a financial statement audit, so the increase in demand for these services may be limited.<sup>501</sup> Thus, although we acknowledge commenters' concerns, we still believe it important that the private fund auditors meet SEC independence requirements and be registered with, and subject to regular inspection, by the PCAOB.

Some industry commenters<sup>502</sup> and a commenter representing CLO investors<sup>503</sup> endorsed an alternative compliance option for CLOs, such as an agreed-upon-procedures engagement, instead of requiring such vehicles to undergo an annual audit. As stated above,<sup>504</sup> we believe that SAFs, including CLOs, have certain distinguishing structural and operational features that warrant carving them out of the private fund rules entirely, including the audit rule. We also believe that an agreed-upon-procedures engagement serves a different purpose than an audit. An agreed-upon procedures engagement is an attestation engagement in which a certified public accountant performs specific procedures agreed upon between the engaging party and the certified public accountant on subject matter and reports findings without providing an opinion or conclusion (*i.e.*, an agreed-upon procedures engagement is not an examination or review engagement).<sup>505</sup> Because the needs of an engaging party may vary widely, the nature, timing, and extent of the procedures may vary, as well.<sup>506</sup> Moreover, the intended users assess for themselves the procedures and findings reported by the certified public accountant and draw

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<sup>501</sup> For example, more than 90% of the total number of hedge funds and private equity funds currently undergo a financial statement audit. *See infra* section VI.C.4.

<sup>502</sup> *See* LSTA Comment Letter; Canaras Comment Letter.

<sup>503</sup> *See* Fixed Income Investor Network Comment Letter.

<sup>504</sup> *See supra* section II.A (Scope) for additional information. The Commission is not applying all five private fund adviser rules to SAFs advised by SAF advisers.

<sup>505</sup> *See* AICPA AT-C 215.02.

<sup>506</sup> *See id.*

their own conclusions from the work performed by the practitioner.<sup>507</sup> An audit, on the other hand, is an examination of an entity's financial statements by an independent public accountant in accordance with either the standards of the PCAOB or generally accepted auditing standards in the United States ("U.S. GAAS") for purposes of expressing an opinion on those financial statements.<sup>508</sup> Although the final approach we are adopting is not identical to commenters' suggestions, we believe it is responsive to suggestions for the audit requirement not to apply to CLOs.

Commenters also requested clarification about whether advisers would need to obtain a separate audit of an SPV to comply with the mandatory audit requirement.<sup>509</sup> We understand that an adviser to a pooled investment vehicle client may utilize an SPV, organized as a limited liability company, trust, partnership, corporation or other similar vehicle, to facilitate investments for legal, tax, regulatory or other similar purposes. We believe an investment adviser could either treat an SPV as a separate client, in which case the adviser will be advising the SPV directly, or treat the SPV's assets as assets of the pooled investment vehicles that it is advising indirectly through the SPV.<sup>510</sup> If the adviser treats the SPV as a separate client, the mandatory private fund audit rule will require the adviser to comply with the rule's audited financial statement distribution requirements.<sup>511</sup> Accordingly, the adviser will distribute the SPV's audited financial statements to the pooled investment vehicle's beneficial owners. If,

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<sup>507</sup> See AICPA AT-C 215.03

<sup>508</sup> See rule 1-02(d) of Regulation S-X.

<sup>509</sup> See E&Y Comment Letter; KPMG Comment Letter; PWC Comment Letter; AIC Comment Letter I; TIAA Comment Letter.

<sup>510</sup> See Custody of Funds or Securities of Clients by Investment Advisers, SEC Investment Advisers Act Release No. IA-2968 (Dec. 30, 2009) [75 FR 1455 (Jan. 11, 2010)] ("2009 Custody Rule Release"), at 41.

<sup>511</sup> See final rule 206(4)-10(a); see also *infra* section II.C.7 (discussing that an adviser needs only to take reasonable steps to cause the private fund, including an SPV, to undergo an audit if the adviser is not in a control relationship).

however, the adviser treats the SPV's assets as the pooled investment vehicle's assets that it is advising indirectly, the SPV's assets will be required to be considered within the scope of the pooled investment vehicle's financial statement audit.

### **1. Requirements for Accountants Performing Private Fund Audits**

Although there are substantive differences between the proposed rule and the final rule, we do not believe that these differences are significant. The mandatory private fund adviser audit rule includes certain requirements regarding the accountant performing a private fund audit, as currently required under the custody rule.<sup>512</sup> First, the rule requires an accountant performing a private fund audit to meet the standards of independence described in Regulation S-X.<sup>513</sup> Second, the rule requires the independent public accountant performing the audit to be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the PCAOB in accordance with its rules.<sup>514</sup>

Some commenters suggested that we should allow auditors to meet AICPA standards of independence as opposed to the standards of independence described in rule 2-01(b) and (c) of Regulation S-X.<sup>515</sup> Another commenter suggested that we should require advisers to rotate their auditors and prohibit auditors to private funds from providing any non-audit services.<sup>516</sup> Under the current custody rule, advisers to pooled investment vehicles qualifying for the audit provision must meet the standards of independence described in Regulation S-X.<sup>517</sup> Based on our

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<sup>512</sup> See final rule 206(4)-10(a) and rule 206(4)-2(d)(3) (defining "independent public accountant").

<sup>513</sup> *Id.*

<sup>514</sup> See final rule 206(4)-10(a) and rule 206(4)-2(b)(4)(ii).

<sup>515</sup> See Ropes & Gray Comment Letter; AIC Comment Letter II.

<sup>516</sup> See SOC Comment Letter.

<sup>517</sup> See rule 206(4)-2(b)(4); see also rule 206(4)-2(d)(3) under the Advisers Act.

experience with the audit provision in the custody rule, we continue to believe that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor confidence.<sup>518</sup> We have long recognized the bedrock principle that an auditor must be independent in fact and appearance, and we believe that the independence standards described in Regulation S-X focus on those relationships or services, including certain non-audit services, that are more likely to threaten an auditor's objectivity or impartiality.<sup>519</sup>

## **2. Auditing Standards for Financial Statements**

Under the mandatory private fund adviser audit rule, an audit must meet the definition in rule 1-02(d) of Regulation S-X, as proposed and as currently required under the custody rule. Pursuant to that definition, financial statement audits performed for purposes of the audit rule would generally be performed in accordance with U.S. GAAS.<sup>520</sup>

Some commenters suggested that we consider whether auditing standards other than U.S. GAAS or PCAOB standards may meet the requirements of the rule,<sup>521</sup> while another commenter stated that “the rule should require advisers to obtain audits performed under rule 1-02(d) of

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<sup>518</sup> See Revision of the Commission's Auditor Independence Requirements, Release No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)]. The custody rule requires all accountants performing services to meet the standards of independence described in rule 2-01(b) and (c) of Regulation S-X. See rule 206(4)-2(d)(3) under the Advisers Act.

<sup>519</sup> See Revision of the Commission's Auditor Independence Requirements, Release No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)], at 5.

<sup>520</sup> Under the definition in rule 1-02(d) of Regulation S-X, an “audit” of an entity (such as a private fund) that is not an issuer as defined in section 2(a)(7) of the Sarbanes-Oxley Act of 2002 means an audit performed in accordance with either U.S. GAAS or the standards of the PCAOB. See 2003 Custody Rule Release, *supra* footnote 470, at n.41. When conducting an audit of financial statements in accordance with the standards of the PCAOB, however, the auditor would also be required to conduct the audit in accordance with U.S. GAAS because the audit would not be within the jurisdiction of the PCAOB as defined by the Sarbanes-Oxley Act of 2002, as amended, (*i.e.*, not an issuer, broker, or dealer). See AICPA auditing standards, AU-C Section 700.46. We believe most advisers will choose to perform the audit pursuant to U.S. GAAS only rather than both standards, though it will be permissible to perform the audit pursuant to both standards.

<sup>521</sup> See E&Y Comment Letter; SBAI Comment Letter; AIMA/ACC Comment Letter; Deloitte Comment Letter.

Regulation S-X, as proposed.”<sup>522</sup> After considering these comments, we continue to believe that audits should be conducted in accordance with U.S. GAAS for the following reasons. First, U.S. GAAS requires that an auditor evaluate and respond to the risk of material misstatements of the financial statements due to fraud or error.<sup>523</sup> Second, audits performed in accordance with U.S. GAAS help detect valuation irregularities or errors, as well as an investment adviser’s loss, misappropriation, or misuse of client investments. Third, other standards may use different or more flexible rules and policies (*e.g.*, the option to follow a standard, rather than an obligation to do so), which may be less effective than U.S. GAAS. Finally, we believe that U.S. investors are more familiar with the procedures performed during a financial statement audit conducted in accordance with U.S. GAAS. A financial statement audit conducted in accordance with U.S. GAAS commonly involves an accountant confirming bank account balances and securities holdings as of a point in time and regularly includes the testing of a sample of transactions, including investor subscriptions and redemptions, that have occurred throughout the year. We believe that the common types of audit evidence procedures performed by accountants during a financial statement audit – physical examination or inspection, confirmation, documentation, inquiry, recalculation, re-performance, observation, and analytical procedures – act as an important check to identify erroneous or unauthorized transactions or withdrawals by the adviser. Thus, we continue to believe that audits should generally be conducted in accordance with U.S. GAAS under this rule.<sup>524</sup>

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<sup>522</sup> Convergence Comment Letter.

<sup>523</sup> See AICPA auditing standards, AU-C Section 240. Audits performed under PCAOB standards provide similar benefits. See PCAOB auditing standards, AS 2401, which discusses consideration of fraud in a financial statement audit.

<sup>524</sup> See *supra* footnote 520.

### 3. Preparation of Audited Financial Statements

The mandatory private fund adviser audit rule also requires the audited financial statements to be prepared in accordance with generally accepted accounting principles as currently required under the custody rule and as proposed.<sup>525</sup> Requiring that financial statements comply with U.S. GAAP or some other comprehensive body of accounting standards similar to U.S. GAAP if the differences are reconciled to U.S. GAAP is designed to help investors receive consistent and quality financial reporting on their investments from the fund's adviser.

We had proposed to require that financial statements of private funds organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States contain information substantially similar to statements prepared in accordance with U.S. GAAP and any material differences must be required to be reconciled to U.S. GAAP. While one commenter suggested that we continue to require audited financial statements prepared in accordance with U.S. GAAP,<sup>526</sup> others suggested that we should recognize other accounting standards outside of the United States, such as International Financial Reporting Standards (IFRS),<sup>527</sup> and not impose a U.S. GAAP requirement.<sup>528</sup> Another commenter indicated that IFRS may be sufficient on their own without also requiring U.S. GAAP financial statements or financials with a reconciliation to U.S. GAAP.<sup>529</sup>

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<sup>525</sup> See final rule 206(4)-10(a) and rule 206(4)-2(b)(4). The SEC has stated that certain financial statements must either be prepared in accordance with U.S. GAAP or prepared in accordance with some other comprehensive body of accounting standards if the information is substantially similar to financial statements prepared in accordance with U.S. GAAP and contain a footnote reconciling any material differences. See 2003 Custody Rule Release, *supra* footnote 470, at n.41.

<sup>526</sup> See Albourne Comment Letter.

<sup>527</sup> See SBAI Comment Letter; Deloitte Comment Letter.

<sup>528</sup> See SIFMA-AMG Comment Letter I; AIC Comment Letter I.

<sup>529</sup> See Deloitte Comment Letter.

We continue to believe that U.S. GAAP is well understood by U.S. investors. U.S. GAAP also has important industry specific accounting principles for certain pooled vehicles, including private funds, and requires measurement of trades on trade date as opposed to settlement date, presentation of a schedule of investments, and certain financial highlights that may not be required under other accounting standards.<sup>530</sup> Thus, we continue to believe that it is important for audited financial statements to be prepared in accordance with U.S. GAAP or some other comprehensive body of accounting standards similar to U.S. GAAP if the differences are reconciled to U.S. GAAP.<sup>531</sup> Under the custody rule, financial statements of private funds organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States are required to contain information substantially similar to statements prepared in accordance with U.S. GAAP and any material differences are required to be reconciled to U.S. GAAP.<sup>532</sup>

#### **4. Distribution of Audited Financial Statements**

The mandatory private fund adviser audit rule requires a fund's audited financial statements to be distributed to current investors within 120 days of the end of a private fund's fiscal year, as currently required under the custody rule.<sup>533</sup> The audited financial statements consist of the applicable financial statements, related schedules, accompanying footnotes, and the audit report.

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<sup>530</sup> See FASB ASC Topic 946, *Financial Services – Investment Companies*.

<sup>531</sup> See rule 206(4)-2(b)(4)(i) and rule 206(4)-2(b)(4)(iii).

<sup>532</sup> See 2003 Custody Rule Release, *supra* footnote 470, at n.41.

<sup>533</sup> See final rule 206(4)-10(a) and rule 206(4)-2(b)(4)(i).

We proposed that the audited financials be distributed “promptly” after the completion of the audit. Commenters requested that we clarify the “promptly” standard,<sup>534</sup> with at least one commenter suggesting an outer limit of 120 days after a fund’s fiscal year end to distribute audited financial statements,<sup>535</sup> while other commenters requested additional flexibility around the time to distribute audited financial statements.<sup>536</sup> After considering these comments, as well as comments urging us not to create disparity between this rule and the audit provision of the custody rule, we are incorporating the custody rule’s timing requirement for the distribution of financial statements into the mandatory private fund adviser audit rule. We believe that, based on our experience with the custody rule, a 120-day time period is generally appropriate to allow the financial statements of a fund to be audited while also balancing the needs of investors to receive timely information.<sup>537</sup> This change will help ensure investors receive the statements in a timely and consistent manner.

In rare instances, an adviser may be unable to distribute a fund’s audited financial statements within the required timeframe because of reasonably unforeseeable circumstances. For example, during the COVID-19 pandemic, some advisers were unable to deliver audited financial statements in the timeframe required under the custody rule due to logistical disruptions. Accordingly, because there is not an alternative method by which to satisfy the rule, the Commission would take the position that, if an adviser is unable to deliver audited

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<sup>534</sup> See NSCP Comment Letter; AIC Comment Letter I; ILPA Comment Letter I.

<sup>535</sup> See Convergence Comment Letter.

<sup>536</sup> See Segal Marco Comment Letter; SBAI Comment Letter.

<sup>537</sup> We similarly believe that a 180-day time period is appropriate in the context of a fund of funds and that a 260-day time period is appropriate in the context of a fund of funds of funds because advisers to these types of pooled investment vehicles may face practical difficulties completing their audits before the completion of audits for the underlying funds in which they invest. We note that our staff has expressed a similar view for certain fund of funds for purposes of the custody rule. See Custody Rule FAQs, *supra* footnote 465, at Question VI.7, VI.8A, and VI.8B.



financial statements in the timeframe required under the mandatory private fund adviser 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.

Under the mandatory private fund adviser audit rule, the audited financial statements must be sent to all of the private fund's investors, as proposed and as currently required under the custody rule.<sup>538</sup> We did not receive any comments on this aspect of the proposal. In circumstances where an investor is itself a limited partnership, limited liability company, or another type of pooled vehicle that is a related person of the adviser, it is necessary to 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 to investors in those pools.<sup>539</sup> Without such a requirement, the audited financial statements would essentially be delivered to the adviser rather than to the parties the financial statements are designed to inform. 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 it is not necessary to look through the structure to make meaningful delivery. It will be sufficient to distribute the audited financial statements to the adviser to, or other designated party of, the unaffiliated fund of funds. We believe that this approach will lead to meaningful delivery of the audited financial statements to the private fund's investors.<sup>540</sup>

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<sup>538</sup> See rule 206(4)-2(b)(4)(i) and rule 206(4)-2(b)(4)(iii).

<sup>539</sup> See final rule 206(4)-10(a) and rule 206(4)-2(c). In a master-feeder structure, master fund financials may be attached to the feeder fund financials and delivered to investors in the feeder fund. See FASB ASC 946-205-45-6.

<sup>540</sup> See rule 206(4)-10(a) and rule 206(4)-2(c).

## 5. Annual Audit, Liquidation Audit, and Audit Period Lengths

Key to the effectiveness of the audit in protecting investors is timely and regular administration and distribution. We are requiring that an audit be obtained at least annually, as proposed.<sup>541</sup> The final mandatory private fund adviser audit rule incorporates the custody rule requirement that audits must be performed *promptly* upon liquidation.<sup>542</sup>

Requiring the audit on an annual basis will help alert investors within months, rather than years, as to whether the financial statements are free of material misstatements and will increase the likelihood of mitigating losses or reducing exposure to other investor harms. Similarly, a liquidation audit will help ensure the appropriate and prompt accounting of the proceeds of a liquidation so that investors can take timely steps to mitigate losses or protect their rights at a time when they may be vulnerable to misappropriation by the investment adviser. We believe that it becomes increasingly difficult to remediate losses or other investor harms resulting from a material misstatement the longer it goes undetected. The audit requirement addresses these concerns while also balancing the cost, burden, and utility of requiring frequent audits.

Requiring the audit on an annual basis is consistent with current practices of private fund advisers that obtain an audit to comply with the custody rule under the Advisers Act, or to satisfy investor demand for an audit, and will provide investors with uniformity in the information they are receiving.<sup>543</sup> Under U.S. GAAS, auditors have an obligation to evaluate whether the current-period financial statements are consistent with those of the preceding period, and any other periods presented and to communicate appropriately in the auditor's report when the

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<sup>541</sup> Final rule 206(4)-10(a); *see* Proposing Release, *supra* footnote 3, at 109; *see also* rule 206(4)-2(b)(4)(i).

<sup>542</sup> *See* rule 206(4)-2(b)(4)(iii).

<sup>543</sup> *See* final rule 206(4)-10(a) and rule 206(4)-2(b)(4)(i).

comparability of financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements.<sup>544</sup> When an investor receives audited financial statements each year from the same private fund, the investor can compare statements year-over-year. Additionally, the investor can analyze and compare audited financial statements across other private funds and similar investment vehicles each year.

With respect to liquidation, we understand that the amount of time it takes to complete the liquidation of a private fund may vary. A number of years might elapse between the decision to liquidate an entity and the completion of the liquidation process. During this time, the fund may execute few transactions and the total amount of investments may represent a fraction of the investments that existed prior to the start of the liquidation process. We further understand that a lengthy liquidation period can lead to circumstances where the cost of an annual audit represents a sizeable portion of the fund's remaining assets.

Commenters suggested that we clarify how these requirements apply to stub period audits.<sup>545</sup> Certain commenters suggested that we should consider a period other than annually for funds that are undergoing a plan of liquidation or a wind down,<sup>546</sup> with at least one commenter expressing concern that the cost of a liquidation audit may outweigh the possible benefits.<sup>547</sup> Although we appreciate commenters' concerns, we are persuaded by commenters who urged us to align the requirements of this rule and the custody rule for several reasons.

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<sup>544</sup> See AICPA auditing standards, AU Section 708.

<sup>545</sup> See KPMG Comment Letter; AIC Comment Letter II; NCREIF Comment Letter; SBAI Comment Letter.

<sup>546</sup> See KPMG Comment Letter; AIC Comment Letter II; Convergence Comment Letter; AIMA/ACC Comment Letter; SBAI Comment Letter.

<sup>547</sup> See Ropes & Gray Comment Letter.

First, the two rules are substantially similar and have substantially similar policy objectives. Second, aligning this rule and the custody rule avoids confusion because most private fund advisers are already aware of what is required to satisfy the audit provision under the custody rule. Third, aligning this rule and the custody rule avoids additional costs and associated burdens due to the two rules' potential differences. We, however, requested comment on how these requirements apply to stub periods when we recently proposed amendments to the custody rule.<sup>548</sup>

## **6. Commission Notification**

The proposed mandatory private fund adviser audit rule would have required an adviser to enter into, or cause the private fund to enter into, a written agreement with the independent public accountant performing the audit to notify the Commission (i) promptly upon issuing an audit report to the private fund that contains a modified opinion and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.<sup>549</sup>

Some commenters asserted that the notification requirement would be of limited benefit to the Commission,<sup>550</sup> while one commenter supported the notification requirement stating that a modified opinion or termination of an auditor constitute serious red flags that warrant early notice to regulators.<sup>551</sup> Another commenter even suggested that we should require advisers to

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<sup>548</sup> See Safeguarding Release, *supra* footnote 467; we have recently reopened the comment period on the Safeguarding rulemaking proposal. Safeguarding Advisory Client Assets; Reopening of Comment Period, Investment Advisers Act Release No. 6384 (August 23, 2023).

<sup>549</sup> See Proposing Release, *supra* footnote 3, at 111.

<sup>550</sup> See NYC Bar Comment Letter II; BVCA Comment Letter; Invest Europe Comment Letter.

<sup>551</sup> See NASAA Comment Letter.

notify investors upon the occurrence of a significant event.<sup>552</sup> After carefully considering these comments, we are not adopting the notification requirement at this time because we are persuaded by commenters who urged us to align the requirements of this rule and the custody rule. However, the Commission recently proposed amendments to the custody rule. As part of the proposed rulemaking, the Commission proposed similar amendments that would require advisers to enter into a written agreement with the independent public accountant performing the audit to notify the Commission (i) within one business day upon issuing an audit report to the entity that contains a modified opinion and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.<sup>553</sup> We are continuing to consider comments received regarding that proposal. Although we are not adopting a notification requirement as part of this rule, we remind advisers that per the instructions to Form ADV, Part 1A, Schedule D, Section 7.B.23.(h), if a private fund adviser has checked “Report Not Yet Received,” the adviser must promptly file an amendment to its Form ADV to update its records once the report is available.<sup>554</sup>

## **7. Taking All Reasonable Steps to Cause an Audit**

We recognize that some advisers may not have requisite control over a private fund client to cause its financial statements to undergo an audit in a manner that satisfies the mandatory private fund adviser rule. This could be the case, for instance, where a sub-adviser is unaffiliated with the fund. In a minor change from proposal, we are clarifying that if a fund is already

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<sup>552</sup> See RFG Comment Letter II.

<sup>553</sup> See Safeguarding Release, *supra* footnote 467.

<sup>554</sup> See SEC Charges Two Advisory Firms for Custody Rule Violations, One Firm for ADV Violations, and Six Firms for Both, (Sept. 9, 2022), *available at* <https://www.sec.gov/news/press-release/2022-156>; *see also* Form ADV, Section 7.B.(1) Private Fund Reporting, Question 23(h).

undergoing an audit, a non-control adviser does not have to take reasonable steps to cause its private fund client to undergo an audit.<sup>555</sup> We made this change to final rule 206(4)-10(b) to be consistent with final rule 206(4)-10(a). Thus, we are requiring that an adviser *take all reasonable steps* to cause its private fund client to undergo an audit that satisfies the rule when the adviser does not control the private fund and is neither controlled by nor under common control with the fund, if the private fund does not otherwise undergo such an audit.<sup>556</sup>

One commenter suggested that the “all reasonable steps” standard is unclear.<sup>557</sup> Commenters also suggested that we remove this requirement for sub-advisers<sup>558</sup> and that we apply the mandatory audit rule only to private funds controlled by the adviser.<sup>559</sup> We recognize that what would constitute “all reasonable steps” depends on the facts and circumstances. We believe, however, that advisers are in the best position to evaluate their control relationships over private fund clients and should be in a position to determine the appropriate steps to satisfy such standard based on their relationship with the private fund and the relevant control person. For example, a sub-adviser that has no affiliation to the general partner of a private fund could document the sub-adviser’s efforts by including (or seeking to include) the requirement in its sub-advisory agreement. Accordingly, we continue to believe that the “all reasonable steps” standard is appropriate.

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<sup>555</sup> Final rule 206(4)-10(b).

<sup>556</sup> *Id.*

<sup>557</sup> *See* Convergence Comment Letter.

<sup>558</sup> *See* BVCA Comment Letter; Invest Europe Comment Letter.

<sup>559</sup> *See* AIMA/ACC Comment Letter.

## 8. Recordkeeping Provisions Related to the Audit Rule

Finally, we are amending the Advisers Act books and records rule to require advisers to keep a copy of any audited financial statements, along with a record of each addressee and the corresponding date(s) sent.<sup>560</sup> In a change from the proposal, we are not requiring private fund advisers to make and retain records of the addresses and delivery methods used to disseminate audited financial statements.<sup>561</sup> Additionally, the adviser will be required to keep a record documenting steps taken by the adviser 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 rule.<sup>562</sup> We did not receive comments on the recordkeeping provisions of the mandatory private fund adviser audit rule. This aspect of the rule is designed to facilitate our staff's ability to assess an adviser's compliance with the mandatory private fund adviser audit rule and to detect risks the proposed audit rule is designed to address. We believe it similarly will enhance an adviser's compliance efforts as well.

### D. Adviser-Led Secondaries

We are requiring SEC-registered advisers to satisfy certain requirements if they initiate a transaction that offers fund investors the option between selling all or a portion of their interests in the private fund and converting or exchanging them for new interests in another vehicle advised by the adviser or any of its related persons (an "adviser-led secondary transaction").<sup>563</sup> First, the adviser must obtain a fairness opinion or a valuation opinion from an independent

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<sup>560</sup> Final amended rule 204-2(a)(21)(i). *See also supra* footnote 452 (describing the record creation and retention requirements under the books and records rule).

<sup>561</sup> *See* the discussion of recordkeeping requirements above in section II.B.6.

<sup>562</sup> Final amended rule 204-2(a)(21)(ii).

<sup>563</sup> Final rule 211(h)(2)-2. The rule does not apply to advisers that are not required to register as investment advisers with the Commission, such as State-registered advisers and ERAs.

opinion provider and distribute the opinion to private fund investors prior to the due date of the election form. Second, 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.<sup>564</sup> Advisers or their related persons have a conflict of interest with the fund and its investors when they offer investors the option between selling their interests in the fund, and converting or exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. This rule will provide an important check against an adviser's conflicts of interest in structuring and leading such a transaction from which it may stand to profit at the expense of private fund investors.

Some commenters supported the proposed rule,<sup>565</sup> including some that stated it would help protect investors by providing them with better information.<sup>566</sup> Other commenters generally opposed the proposed rule.<sup>567</sup> Some commenters suggested that we expand the final rule to offer additional protections to investors, such as requiring advisers to use reasonable efforts to allow investors to remain invested on their original terms without the adviser realizing any carried

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<sup>564</sup> The Commission recently adopted certain new reporting requirements for private funds on Form PF. *See* Form PF; Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers; Requirements for Large Private Equity Fund Adviser Reporting, Investment Advisers Act Release No. 6297 (May 3, 2023) ("Form PF Release") (17 CFR Parts 275 and 279). Among these new reporting requirements is an obligation for certain private equity funds to report adviser-led secondary transactions on Form PF on a quarterly basis. While the adviser-led secondary transaction reporting requirement on Form PF and the adviser-led secondary transaction requirements in the final rule both serve, at least in part, to further investor protection, they do so through different means, entail different burdens, and employ modified definitions. The adviser-led secondary transaction reporting requirement on Form PF is confidential and thus does not provide investors with additional information. The adviser-led secondary transaction requirements in this rule, on the other hand, are designed to, among other things, make investors better informed about adviser-led secondary transactions in which they may be participating.

<sup>565</sup> *See, e.g.*, CFA Comment Letter I; ICM Comment Letter; Morningstar Comment Letter; NEBF Comment Letter; Segal Marco Comment Letter.

<sup>566</sup> *See, e.g.*, Better Markets Comment Letter; Healthy Markets Comment Letter I; NY State Comptroller Comment Letter.

<sup>567</sup> *See, e.g.*, Comment Letter of the National Association of College and University Business Officers (Apr. 25, 2022) ("NACUBO Comment Letter"); SIFMA-AMG Comment Letter I; ATR Letter; PIFF Comment Letter; NYC Bar Comment Letter II; Ropes & Gray Comment Letter.



interest on the sale of underlying assets.<sup>568</sup> While we understand that investors have other concerns surrounding these types of transactions,<sup>569</sup> we remain focused on providing investors with information that will enable them to make educated and informed decisions about their investments, particularly when such decisions involve a conflicted transaction, and we believe fairness and valuation opinions address that concern.<sup>570</sup> Fairness opinions and valuation opinions help investors make educated and informed investment decisions because they assist investors in gaining a more complete understanding of the financial aspects of the transaction. Moreover, we believe the opinion requirement is better suited to address the conflicts inherent within adviser-led secondary transactions because the presence of an independent third party reduces the possibility of fraudulent, deceptive, or manipulative activity. It also reduces the possibility that the subject asset may be valued opportunistically and that the adviser's compensation may involve fraud or deception, resulting in an inappropriate compensation scheme.

Some commenters argued that the SEC would exceed its authority if it were to require advisers to obtain a fairness opinion and that the proposed rule conflicts with SEC statements

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<sup>568</sup> See, e.g., RFG Comment Letter II; OPERS Comment Letter (asking the Commission to provide additional relief, such as allowing investors to participate in the continuation fund on the same terms that applied to the investor's investment in the initial fund).

<sup>569</sup> For example, one commenter suggested we should encourage private funds to appoint independent transfer administrators and create secondary transfer policies. See Comment Letter of NYPPEX Holdings, LLC (Feb. 25, 2022) ("NYPPEX Comment Letter"). Another commenter suggested that we should require advisers to carry forward relevant side letter provisions to any new investment vehicle when those provisions were already negotiated and accepted by an adviser in respect of the original investment fund. See NY State Comptroller Comment Letter.

<sup>570</sup> Several commenters stated that providing full and fair disclosure concerning the conflicts and material facts associated with an adviser-led secondary transaction and receiving informed consent from investors is the most effective method to address the associated conflicts. See, e.g., BVCA Comment Letter; Invest Europe Comment Letter. However, it is not possible for an investor to receive full and fair disclosure concerning the material facts associated with an adviser-led secondary transaction if the underlying valuation is determined only by the adviser without any third-party check. We also discuss further economic considerations around the viability of disclosure or consent requirements in the case of adviser-led secondaries below. See *infra* sections VI.C.2, VI.C.4.

that advisers and clients can shape their relationships by agreement, provided that there is appropriate disclosure.<sup>571</sup> Section 206(4) grants the SEC the authority to prescribe means that are reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, and courses of business. The final rule is reasonably designed to achieve this goal because it addresses an adviser's conflicts of interest that arise when leading a secondary transaction. Generally, the adviser is incentivized to recommend for the private fund to participate in the transaction by selling the asset to a new vehicle that survives the transaction, often referred to as the "continuation vehicle," because the adviser and its related persons will typically receive additional management fees and carried interest from managing the continuation vehicle. Specifically, the adviser will be incentivized to seek a lower sale price for the asset to benefit the continuation fund because a lower sale price will increase the potential for more carried interest out of the continuation fund in the future. Additionally, an adviser may seek to undervalue an asset subject to a secondary transaction if the adviser's economics in the continuation fund are greater than its economics in the existing fund. This would harm investors in the existing fund because their cash-out offer would be based on an underlying valuation that is below market value. As another example, if the adviser-led secondary required a "stapled commitment" to another vehicle whereby secondary buyers were required to make contemporaneous capital commitments to another vehicle, the price offered to the fund's investors could be adversely affected if the staple requirement reduces the amount prospective buyers are willing to pay. By ensuring that private fund investors that participate in a secondary transaction are offered an appropriate price and provided disclosures about the opinion provider's relationship with the adviser, the rule will help prevent acts that are fraudulent, deceptive, or manipulative. If

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<sup>571</sup> See, e.g., ATR Comment Letter; Ropes & Gray Comment Letter; AIC Comment Letter I.

investors receive the benefit of a third-party check on valuation and are made aware of any conflicts of interest between the opinion provider and the adviser, investors are less likely to be defrauded, deceived, or manipulated by a mis-valuation by the adviser in its own interest.

One commenter argued that the proposed rule would be contrary to Section 211(h) of the Advisers Act because the proposed rule would significantly and needlessly expand an adviser's obligations and would disadvantage investors and the industry.<sup>572</sup> Section 211(h)(2) authorizes the Commission to prohibit or restrict certain sales practices, conflicts of interest, or compensation schemes that the Commission deems contrary to the public interest and the protection of investors. As discussed above in this section, an adviser-led secondary transaction raises certain conflicts of interest because the adviser and its related persons typically are involved on both sides of the transaction. As a result, advisers may seek to undervalue or overvalue an underlying asset involved in the transaction, at the expense of the private funds they advise, depending on how the economics of the transaction most benefit them. The conflicts of interest associated with adviser-led secondary transactions are particularly harmful to investor protection because they are often not made transparent to investors. These conflicts can also harm investors that elect to roll into the new vehicle advised by the same adviser. For example, the conflicts may influence or alter the terms the adviser sets forth in the new vehicle's governing agreement to the detriment of investors. Because investors typically do not have withdrawal rights, they may be subject to those terms for an extended period of time.

Adviser-led secondary transactions also involve compensation schemes as, typically, the adviser receives compensation as a result of the transaction. Advisers stand to profit from being on both sides of the transaction by earning additional compensation in the form of management

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<sup>572</sup> See Ropes & Gray Comment Letter.

fees or carried interest which is ultimately paid by fund investors. For example, in the continuation fund context, when an asset is sold from an existing fund to the continuation fund, the adviser has the potential to realize carried interest as part of that sale, depending on the performance of the existing fund. Advisers are thus incentivized to over- or undervalue the underlying asset depending on how they will receive the most compensation. This rule's requirement that private fund investors receive a third-party check on price via a fairness or valuation opinion and are provided disclosures about the opinion provider's relationship with the adviser will help protect them against such conflicted compensation schemes.

One commenter stated that, if adopted, this rule would be the first and only Federal securities law requiring a fairness opinion.<sup>573</sup> While the Federal securities laws generally do not require fairness opinions, they have required disclosure of fairness findings, including by independent parties, in other conflicted transactions. For example, in certain going-private transactions, Regulation M-A requires the filer to provide information regarding the substantive and procedural fairness of the transaction to address concerns related to self-dealing and unfair treatment, including whether the transaction is fair or unfair to unaffiliated security holders.<sup>574</sup> We believe that, due to these and other requirements applicable to going-private transactions, companies (or their affiliates) often obtain fairness opinions from independent opinion providers as a matter of best practice. Thus, other Federal securities laws, such as Regulation M-A, have required, or otherwise have indirectly caused, fairness findings similar to those required in the opinion provision of the final rule.

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<sup>573</sup> See NYC Bar Comment Letter II.

<sup>574</sup> See 17 CFR 229.1000.

After considering comments, we are adopting this rule largely as proposed. In contrast to the proposal, we are providing advisers the option to obtain a valuation opinion *or* a fairness opinion, and we are requiring distribution of the opinion and the summary of material business relationships before the due date of the binding election form.

### **1. Definition of Adviser-led Secondary Transaction**

Adviser-led secondary transactions are defined as transactions initiated by the investment adviser or any of its related persons that offer the private fund's investors the choice between: (i) selling all or a portion of their interests in the private fund and (ii) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.<sup>575</sup>

This definition generally includes secondary transactions where a fund is selling one or more assets to another vehicle managed by the adviser, if investors have the option between obtaining liquidity and rolling all or a portion of their interests into the other vehicle. Examples of such transactions may include single asset transactions (such as the fund selling a single asset to a new vehicle managed by the adviser), strip sale transactions (such as the fund selling a portion of multiple assets to a new vehicle managed by the adviser), and full fund restructurings (such as the fund selling all of its assets to a new vehicle managed by the adviser).<sup>576</sup>

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<sup>575</sup> Final rule 211(h)(1)-1. In a change from the proposal and in response to commenters, we are modifying the definition of an "adviser-led secondary transaction" from the proposal to exclude tender offers generally by revising the definition to require a choice between clauses (i) *and* (ii). *See* the discussion of the change to this definition in this section below.

<sup>576</sup> One commenter stated that the proposed definition of an "adviser led secondary transaction" may inadvertently pick up certain types of routine cross-trades. *See* Ropes & Gray Comment Letter. We would not consider the rule to apply to cross trades (which, generally, include sales of assets from one fund managed by an adviser to another fund managed by the same adviser) where the adviser does not offer the private fund's investors the choice to sell, convert, or exchange their fund interest. Although not subject to this rule, such cross trades may implicate other Federal securities laws, rules, and regulations, such as sections 206(1) and (2) of the Advisers Act.

We generally would consider a transaction to be initiated by the 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. However, whether the adviser or its related person initiates a secondary transaction requires a facts and circumstances analysis. We generally would not view a transaction as initiated by the adviser if the adviser, at the unsolicited request of the investor, assists in the secondary sale of such investor's fund interest.

Adviser-led transactions raise certain conflicts of interest because the adviser and its related persons are involved on both sides of the transaction and have interests in the transaction that are different from, or in addition to, the interests of the private fund investors. For example, because the adviser may have the opportunity to earn economic and other benefits conditioned upon the closing of the secondary transaction, such as additional management fees or carried interest (including "premium" carry), the adviser generally has a conflict of interest in setting and negotiating the transaction terms. We believe that the definition is sufficiently broad to remain evergreen as secondary transactions continue to evolve and capture transactions that present these or other conflicts of interest. It also is sufficiently narrow to avoid capturing certain types of transactions that would not raise the same regulatory and conflict of interest concerns. For example, some commenters expressed concerns that the definition would capture rebalancing between parallel funds, "season and sell" transactions, and other scenarios where it may be unclear whether the adviser initiated the transaction.<sup>577</sup> Rebalancing between parallel

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<sup>577</sup> See, e.g., Ropes & Gray Comment Letter; SBAI Comment Letter. In a typical season and sell transaction, one entity originates a loan and then, after the conclusion of a "seasoning period," sells the loan to an affiliated entity. See The Investment Lawyer, Covering Legal and Regulatory Issues of Asset Management, Jessica T. O'Mary (July 2019), at 3-4.

funds and season and sell transactions between parallel funds generally will not be captured by the “adviser-led secondary transaction” definition because the adviser is not offering investors the choice between selling and converting/exchanging their interests in the private fund. Instead, the adviser is moving or reallocating assets between private funds it advises for legal and/or tax reasons. Rebalancing and season and sell transactions are important tools that assist an adviser in managing a fund’s operations. For example, rebalancing allows an adviser to ensure that its fund clients have appropriate exposure to an investment to carry out the funds’ investment strategies. Also, season and sell transactions are primarily used to reduce taxes and may allow an adviser to accommodate investors with different tax needs. Advisers and investors will benefit from continuing to access these tools, without the need for a fairness opinion.

In the Proposing Release, we classified “tender offers” as falling within the definition of “adviser-led secondary transactions” and we requested comment on this treatment and asked whether the rule should treat tender offers differently. Some commenters responded that the definition should not capture tender offers where the adviser or its related person is not acting as the purchaser.<sup>578</sup> These commenters stated that a fairness opinion would not add value for these types of transactions because investors typically have discretion to determine whether to remain in the fund on their existing terms or sell their interests for the price offered and that the default in a tender offer is for the investor to maintain its “*status quo*” interest in the fund. One commenter suggested that we revise the definition of adviser-led secondaries to more appropriately narrow its scope by clarifying that the definition requires that investors must

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<sup>578</sup> See, e.g., AIC Comment Letter II; NYC Bar Comment Letter II.

choose *between* selling their interest in a private fund and converting or exchanging their interest for an interest in another vehicle advised by the same adviser.<sup>579</sup>

We found commenters’ statements on this point persuasive in the context of this rule and, in a change from the proposal, are revising the rule text to exclude tender offers generally from the definition of “adviser-led secondary transactions.” We have modified the definition from the proposal to establish that the definition contemplates a choice between clauses (i) and (ii) of the definition. Accordingly, tender offers will not be captured by the definition if an investor is not faced with the decision between (1) selling all or a portion of its interest and (2) converting or exchanging all or a portion of its interest. Generally, if an investor is allowed to retain its interest in the same fund with respect to the asset subject to the transaction on the same terms (i.e., the investor is not required to either sell or convert/exchange), as many tender offers permit investors to do, then the transaction would not qualify as an adviser-led secondary transaction.<sup>580</sup>

## **2. Fairness Opinion or Valuation Opinion**

To complete an adviser-led secondary transaction, advisers must either (i) obtain a written opinion stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair (a “fairness opinion”), or (ii) obtain a written opinion stating the value (as a single amount or a range) of any assets being sold (a “valuation opinion”).<sup>581</sup> In a change from the proposal, and in response to comments, we are allowing

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<sup>579</sup> See, e.g., Comment Letter of Cravath, Swaine & Moore LLP (Apr. 11, 2022) (“Cravath Comment Letter”); NYC Bar Comment Letter II.

<sup>580</sup> An attempt to avoid any of the rule’s requirements, depending on the facts and circumstances, could violate the Act’s general prohibition against doing anything indirectly which would be prohibited if done directly. Section 208(d) of the Advisers Act.

<sup>581</sup> See final rule 211(h)(1)-1 (defining “fairness opinion” and “valuation opinion”).



advisers to have the option to obtain and distribute to investors a valuation opinion instead of a fairness opinion.

Many commenters supported the proposed requirement that advisers obtain a fairness opinion in part because they believed it would provide investors with important information to inform their decisions.<sup>582</sup> Others stated that requiring fairness opinions would be overly burdensome because they would increase transaction costs.<sup>583</sup> Several commenters suggested that we offer alternatives to the fairness opinion requirement, and some commenters suggested we allow advisers to obtain valuation opinions in lieu of a fairness opinion.<sup>584</sup> We continue to believe that requiring a third-party check on valuation is a critical component of preventing the type of harm that might result from the adviser's conflict of interest in structuring and leading a secondary transaction.<sup>585</sup> Requiring advisers to obtain an independent opinion would provide private fund investors assurance that the price being offered is based on an appropriate valuation. We are receptive to commenters' concerns, however, that requiring a fairness opinion could result in increased costs to investors and that there may be other mechanisms to provide investors with unconflicted, objective data about the value of assets that are the subject to an adviser-led secondary transaction.<sup>586</sup> We understand that, in some cases, the cost of a valuation opinion would be lower than a fairness opinion, but that a valuation opinion would still provide investors

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<sup>582</sup> See, e.g., Segal Marco Comment Letter (stating that the fairness opinion requirement would “help investors receive independent price assessments”); Better Markets Comment Letter; NY State Comptroller Comment Letter.

<sup>583</sup> See, e.g., AIC Comment Letter I; AIMA/ACC Comment Letter; PIFF Comment Letter.

<sup>584</sup> See, e.g., SBAI Comment Letter; Comment Letter of Houlihan Lokey, Inc. (Apr. 25, 2022) (“Houlihan Comment Letter”); IAA Comment Letter II.

<sup>585</sup> As a fiduciary, the adviser is obligated to act in the fund's best interest and to make full and fair disclosure to the fund of all conflicts and material facts associated with the adviser-led transaction.

<sup>586</sup> See, e.g., AIMA/ACC Comment Letter; Houlihan Comment Letter.

with a strong basis to make an informed decision.<sup>587</sup> Namely, a valuation opinion would also provide a third-party check on valuation which is critical to addressing the conflicts of interest inherent in adviser-led secondary transactions.<sup>588</sup> Under the final rule, advisers and investors will have the ability to negotiate whether a fairness opinion or valuation opinion is more appropriate.

Several commenters suggested that we exempt adviser-led transactions where price can otherwise be determined through a market-driven discovery process independent of the adviser, such as when a recent sale of a minority stake in the relevant portfolio investment has occurred or shares of an underlying asset are publicly traded.<sup>589</sup> Although such transactions can provide helpful data that can inform a valuation opinion or fairness opinion, the valuation ascribed to the asset in such a transaction may not represent an accurate value. For example, valuations obtained through a minority stake sale may become stale relatively quickly.<sup>590</sup> In the context of an underlying asset that is publicly traded, the market price may be highly volatile or the publicly traded security may have limited trading volume. In addition to timing, each transaction is

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<sup>587</sup> See Houlihan Comment Letter.

<sup>588</sup> We believe that any fairness or valuation opinions provided pursuant to the final rule should nonetheless be in line with market practices and methodologies. For example, we understand that, currently, many fairness and valuation opinions rely on discounted cash flow, similar transaction, similar company, and/or other comparable analyses. We recognize, however, that each of these types of analyses may not be possible in all circumstances or otherwise applicable to the transaction type, and that other types of analysis may be appropriate.

<sup>589</sup> See, e.g., Cravath Comment Letter; Comment Letter of Carta, Inc. (Apr. 25, 2022) (“Carta Comment Letter”); Albourne Comment Letter; Pathway Comment Letter; ILPA Comment Letter I; IAA Comment Letter II; AIC Comment Letter I.

<sup>590</sup> Some commenters suggested that valuations obtained within 12 months of the adviser’s solicitation of investor interest in the adviser-led secondary transaction would provide acceptable valuation information. See Cravath Comment Letter (suggesting that the final rule exempt from the fairness opinion requirement transactions where an asset was the subject of a liquidity event within the last 12 months, among other requirements); ILPA Comment Letter I. However, we believe that 12 months is too long a period of time and would not allow the price to reflect the market’s more recent pricing changes. Significant market changes (for instance, the global spread and response to COVID-19) can occur in a substantially shorter time period than 12 months.

unique, and factors such as size of the asset being sold and whether the purchaser is obtaining a controlling interest could result in a valuation that is not as relevant to an adviser-led secondary transaction involving the same asset, depending on the facts and circumstances. Another example of a distinct transaction is a scenario where a strategic purchaser may be willing to pay more because the purchaser has a plan for realizing synergies with the target company after the acquisition (*e.g.*, reduced costs). In contrast, a purchaser that does not have immediate plans for the target company might only be willing to pay a reduced amount.

Some commenters supported the fairness opinion requirement as a guard against suspect valuations, especially when such valuations determine the carried interest, management fees, and/or other transaction fees an adviser may receive from the transaction.<sup>591</sup> We share these concerns and decline to provide an exemption from the fairness/valuation opinion requirement for market-driven discovery processes. We do not believe that relying solely on market-driven transactions is sufficient to address the policy concerns that motivated this rule. Although commenters argued that a fairness opinion is unnecessary in certain market-driven transactions, such as a minority stake sale, we believe that some of the same conflicts of interest, compensation scheme concerns, and potential for fraud or manipulation that motivated this rulemaking may persist in such market-driven transactions because the adviser is still involved in deciding whether to engage in the transaction and still sets and negotiates the terms of that sale. For example, if a recent sale improperly valued an asset, an adviser could be incentivized to initiate a transaction with the same valuation, which, depending on the terms of the transaction, may benefit the adviser at the expense of the investors. Similarly, if the market price of shares in a publicly traded underlying asset is volatile and drops suddenly or is depressed for an extended

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<sup>591</sup> See, *e.g.*, Healthy Markets Comment Letter I; Better Markets Comment Letter; OPERS Comment Letter.

period of time, an adviser may be incentivized to seek to execute an adviser-led secondary with respect to such asset as soon as possible to lock in the lower price to the detriment of investors.<sup>592</sup> As a result, our concerns about an adviser's conflicts of interest are not fully addressed by relying on such valuations for such transactions. Instead, we believe that a methodological process performed by a third party (such as that used to produce a fairness/valuation opinion) that takes into account factors when analyzing value, including but not limited to recent market transactions, will provide investors with reliable data to inform their decision-making process.<sup>593</sup> This rule will also serve as a deterrent to harmful conflicts of interest, compensation schemes and fraudulent or manipulative behavior because any valuation proposed by an adviser would need to be checked by an opinion provider. Thus, we believe that advisers will be less likely to propose such valuations if they anticipate that an opinion provider may not support them.

Some commenters suggested that we expand the fairness opinion requirement to cover information in addition to pricing/valuation of the asset (*e.g.*, data and pricing information for the remaining assets in the fund).<sup>594</sup> In contrast, other commenters did not support an expansion in scope on the grounds that requiring transaction terms in an opinion would require the opinion provider to make subjective judgments, and adding other provisions, such as allowing the private fund and/or its investors to rely on the opinion, would increase the cost of fairness opinions.<sup>595</sup>

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<sup>592</sup> We recognize, however, that most adviser-led transactions do not involve publicly traded securities and typically involve financial assets that are valued using unobservable inputs as described in FASB ASC Topic 820, *Fair Value Measurement*, *i.e.*, level 3 inputs.

<sup>593</sup> *See supra* the discussion of appropriate methodologies in footnote 588.

<sup>594</sup> *See, e.g.*, NYPPEX Comment Letter; Segal Marco Comment Letter.

<sup>595</sup> *See, e.g.*, Houlihan Comment Letter (stating that the final rule should not require the fairness opinion to state that the private fund and/or its investors may rely on the fairness opinion); AIMA/ACC Comment Letter; Cravath Comment Letter.

We agree with these commenters that an expansion in scope is not necessary to address the conflict of interest that underlies the need for this rule: concern that an adviser's conflicts of interest (due to being on both sides of the transaction) will result in a price/valuation that does not reflect the true value of the asset. As noted above, an adviser's economic entitlements will likely be based on the asset value and the fairness/valuation opinion requirement is intended to guard against the adviser's incentive to value an asset in a manner that maximizes the adviser's profit.

The final rule requires an adviser to obtain the opinion from an independent opinion provider, which is defined as a person that provides fairness opinions or valuation opinions in the ordinary course of its business and is not a related person of the adviser.<sup>596</sup> The requirement that the opinion provider not be a related person of the adviser reduces the risk that certain affiliations could result in a biased opinion and would further mitigate the potential influence of the adviser's conflicts of interest. The ordinary course of business requirement is intended to capture persons with the experience to value illiquid, esoteric, and other types of assets based on relevant criteria.

One commenter suggested expanding the proposed definition of "independent opinion provider" to allow a broader group of opinion providers to satisfy the definition (*i.e.*, beyond entities that provide opinions about assets sold as part of adviser-led secondary transactions in the ordinary course of their business).<sup>597</sup> We decline to broaden the types of entities that can serve as independent opinion providers because it is important that opinion providers have the

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<sup>596</sup> See final rule 211(h)(1)-1 (defining "independent opinion provider"). See *supra* section II.B.1 for a discussion of the definition of "related person."

<sup>597</sup> See Ropes & Gray Comment Letter.

necessary experience to value assets in connection with adviser-led secondary transactions. We are adopting the definition of “independent opinion provider” largely as proposed.<sup>598</sup>

### **3. Summary of Material Business Relationships**

We also are requiring advisers to prepare a written summary of 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. We are adopting this requirement largely as proposed, but we are specifying that the lookback period for which disclosures must be provided for material business relationships that existed during the two-year period is measured from *immediately prior to the issuance of the fairness opinion or valuation opinion*. We believe that specifying how the lookback period is measured will facilitate the effective operation of the rule and will ensure that investors receive relevant information about an adviser’s conflicts at the time the opinion was issued by the independent opinion provider. Moreover, we believe it is important to measure this two-year period from immediately prior to the issuance of the fairness opinion or valuation opinion to capture any new material business relationships that may have developed only shortly before the issuance of such opinion.

We are adopting this requirement because other business relationships may have the potential to result, or appear to result, in a biased opinion, particularly if such relationships are not disclosed to private fund investors. For example, an opinion provider that receives an income stream from an adviser for performing services unrelated to the issuance of the opinion might not want to jeopardize its business relationship with the adviser by alerting the private

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<sup>598</sup> In a minor change from the proposed definition of “independent opinion provider,” we are replacing “an entity” with “a person.” “Person,” as defined under the Advisers Act includes natural persons as well as entities. Section 202(a)(16) of the Act [15 U.S.C. 80b-2(a)(16)].

fund investors that the price being offered is unfair (or by otherwise refusing to issue the opinion). By requiring disclosure of such material relationships, the rule puts private fund investors in a position to evaluate whether any conflicts associated with such relationships may cause the opinion provider to deliver a biased opinion. This required disclosure would also deter advisers from seeking opinions from highly conflicted opinion providers as it may raise objections from investors. 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.

Some commenters stated that this requirement is unnecessary because advisers are already required to disclose material conflicts of interest to private fund investors.<sup>599</sup> We recognize that an adviser has an obligation to comply with rule 206(4)-8 under the Advisers Act and avoid omitting material facts, but that rule does not impose an affirmative obligation on advisers to provide specific disclosure on their conflicts of interest. In contrast, the final rule would mandate disclosure that covers a discrete time period and that must be provided to investors at a time when investors can use the information to make investment decisions. These specific requirements are necessary to address the conflicts of interest that adviser-led secondary transactions present.

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<sup>599</sup> See, e.g., PIFF Comment Letter; Ropes & Gray Comment Letter.

#### 4. Distribution of the Opinion and Summary of Material Business Relationships

Under the final rule, an adviser must distribute<sup>600</sup> the fairness opinion or valuation opinion as well as the summary of material business relationships to private fund investors. In a change from the proposal, and in response to comments, we are requiring that the adviser distribute both the opinion and summary of material business relationships to private fund investors prior to the *due date of the election form* for the transaction instead of prior to *the closing of the transaction*.<sup>601</sup> We requested comment on the distribution of the fairness opinion and summary of material business relationships.<sup>602</sup> Several commenters suggested that the final rule specify the timing required for delivery of the opinion to ensure that investors have sufficient time to use the information to inform their investment decisions.<sup>603</sup> One commenter stated that it is common for advisers to obtain the opinion well in advance of the closing of the transaction because the adviser delivers it to the investors or the LPAC at an earlier stage of a transaction to provide such persons with the relevant information to make a determination as to whether to waive conflicts and allow the transaction to proceed.<sup>604</sup> We agree that specifying the timing for delivery will ensure that investors receive the benefit of an independent price assessment at the time they make an investment decision with respect to the transaction, which

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<sup>600</sup> Advisers may distribute the fairness opinion or valuation opinion as well as the summary of material business relationships to private fund investors electronically, including through a data room, provided that such distribution is done in accordance with the Commission's views regarding electronic delivery. *See* Use of Electronic Media Release, *supra* footnote 435; *see also* *supra* section II.B.3- for a discussion of the distribution requirements.

<sup>601</sup> We also have added the defined term "election form" which means a written solicitation distributed by, or on behalf of, the adviser or any related person requesting private fund investors to make a binding election to participate in an adviser-led secondary transaction. *See* final rule 211(h)(1)-1.

<sup>602</sup> *See* Proposing Release, *supra* footnote 3, at 130.

<sup>603</sup> *See, e.g.*, Predistribution Initiative Comment Letter II; ILPA Comment Letter I.

<sup>604</sup> *See* Ropes & Gray Comment Letter.



will make them better informed about the transaction. Moreover, this will make the rule a more effective deterrent to conflicts and excessive compensation and help prevent fraud, deception, and manipulation than our proposed approach because it will better ensure that investors have access to important information regarding valuation and conflicts at the time they make a binding decision to participate in the transaction, rather than after this decision has been made.

## **5. Recordkeeping for Adviser-Led Secondaries**

We are amending rule 204-2 under the Advisers Act to require advisers to make and retain books and records to support their compliance with the adviser-led secondaries rule and facilitate the Commission's inspection and enforcement capabilities.<sup>605</sup> 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. In a change from the proposal, we are adding a reference to the valuation opinion consistent with the change discussed above allowing an adviser to obtain a valuation opinion in lieu of a fairness opinion. In another change from the proposal, we are not requiring private fund advisers to make and retain records of the addresses or delivery methods used to disseminate fairness opinions, valuation opinions, or material business relationship summaries.<sup>606</sup>

Some commenters supported the recordkeeping requirement.<sup>607</sup> Another commenter stated that the requirement would be overly burdensome for advisers to funds with a significant number of investors.<sup>608</sup> While we understand that the rule imposes an additional recordkeeping

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<sup>605</sup> Final amended rule 204-2(a)(23).

<sup>606</sup> See the discussion of recordkeeping requirements above in section II.B.6.

<sup>607</sup> See, e.g., ILPA Comment Letter I; Convergence Comment Letter.

<sup>608</sup> See AIMA/ACC Comment Letter.

obligation on advisers, ultimately advisers are not obligated to engage in adviser-led secondary transactions. Because these transactions are optional and up to the adviser's discretion, an adviser can consider the associated recordkeeping requirements when deciding whether to initiate such a transaction. Also, as noted above, we are not adopting the proposed address and delivery method recordkeeping requirements; thus, the final rule lessens the recordkeeping burden on advisers compared to the proposal. Further, we view these requirements as necessary to facilitate our staff's ability to assess an adviser's compliance with the final rule and enhance an adviser's compliance efforts.

#### **E. Restricted Activities**

In a modification from the proposal, final rule 211(h)(2)-1 restricts advisers to a private fund from engaging in the following activities, unless they satisfy certain disclosure and, in some cases, consent requirements:

- Charging or allocating to the private fund fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority; however, regardless of any disclosure or consent, an adviser may not charge or allocate fees and expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for violating the Investment Advisers Act of 1940 or the rules promulgated thereunder;
- Charging the private fund for any regulatory, examination, or compliance fees or expenses of the adviser or its related persons;

- Reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders;
- Charging or allocating fees and expenses related to a portfolio investment on a non-pro rata basis when more than one private fund or other client advised by the adviser or its related persons have invested in the same portfolio company; and
- Borrowing money, securities, or other private fund assets, or receiving a loan or extension of credit, from a private fund client.

We proposed to prohibit these activities without disclosure or consent exceptions.<sup>609</sup>

Like the proposal, the final rule applies even if the activities are performed indirectly, for example by an adviser's related persons, because the activities have an equal potential to harm the fund and its investors when performed indirectly without the specified disclosure, and in some cases, consent.<sup>610</sup>

We requested comment on the proposed prohibitions, including on whether the final rule should prohibit these activities unless the adviser satisfies certain governance or other conditions, such as disclosures to the private fund's investors, approval by an independent representative of the fund, or approval by a majority (by number and/or in interest) of investors.<sup>611</sup> Many commenters disagreed with our proposed approach of prohibiting certain activities as *per se* unlawful, and some commenters suggested that the existing full and fair disclosure and informed

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<sup>609</sup> See proposed rule 211(h)(2)-1.

<sup>610</sup> Any attempt to evade any of the rules' restrictions, depending on the facts and circumstances, would violate the Act's general prohibitions against doing anything indirectly which would be prohibited if done directly. Section 208(d) of the Advisers Act.

<sup>611</sup> See Proposing Release, *supra* footnote 3, at 135 and 161.

consent framework for conflicts of interest with advisory clients under the Advisers Act was sufficient to address the Commission’s concerns with these activities.<sup>612</sup>

Other commenters generally supported the proposed prohibitions, stating that they would prevent advisers from engaging in activities that generally disadvantage and shift costs to funds and their investors.<sup>613</sup> Some commenters who supported the Commission’s concerns with these activities suggested that enhanced disclosure or consent requirements would be sufficient to address them and would help avoid some of the unintended consequences that could result from strictly prohibiting the activities (*e.g.*, potentially discouraging advisers from engaging in complex strategies which, according to commenters, would result in decreased competition and diversification).<sup>614</sup> For example, some commenters supported, as an alternative to the proposed prohibition on advisers’ charging regulatory and compliance expenses, requiring advisers to disclose all compliance costs and whether the adviser or fund pays them.<sup>615</sup> Other commenters suggested that we should not prohibit advisers from charging fully disclosed, and consented to,

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<sup>612</sup> See, *e.g.*, Comment Letter of Joseph A. Grundfest, Professor of Law and Business, Stanford Law School Commissioner (Apr. 22, 2022) (“Grundfest Comment Letter”) (stating the Commission has traditionally a disclosure-based philosophy); Cartwright et al. Comment Letter (discussing the SEC’s ability to address activity that is the subject of the proposal through its existing antifraud authority); AIMA/ACC Comment Letter (stating its preference for an “implied consent” framework but also that “disclosure to and more explicit consent—whether by the relevant governing body . . . or by investors individually . . . or collectively (*e.g.*, through an investor consent obtained in the manner prescribed by, and subject to the terms of, a private funds’ governing documents)—to be significantly better (and more in line with the best interests of investors) than an outright ban on such activities” and that “such a disclosure and express consent model would eliminate any residual confusion regarding what is or is not permissible”); MFA Comment Letter I (stating that the Commission has departed from its longstanding approach which was to allow advisers and clients/investors to shape their relationships through disclosure and informed consent); IAA Comment Letter II; AIC Comment Letter II (stating that “requiring separate consent (let alone an outright prohibition) with respect to such activities [in addition to the existing consent framework] would be unnecessary and duplicative”).

<sup>613</sup> See, *e.g.*, NEBF Comment Letter; Predistribution Initiative Comment Letter II; NY State Comptroller Comment Letter; Take Medicine Back Comment Letter; IFT Comment Letter.

<sup>614</sup> See, *e.g.*, Comment Letter of Canada Pension Plan Investment Board (June 22, 2022) (“Canada Pension Comment Letter”) (suggesting that the SEC require disclosure of certain activities rather than prohibiting them outright); SBAI Comment Letter; MFA Comment Letter I.

<sup>615</sup> See, *e.g.*, Schulte Comment Letter; ILPA Comment Letter I.

fees and expenses to their private fund clients<sup>616</sup> and that we should provide an exception for non-pro rata fee and expense charges or allocations if they were appropriately disclosed to investors.<sup>617</sup>

We continue to believe that these activities involve conflicts of interest (*e.g.*, borrowing directly from a private fund client may benefit the adviser while not being in the best interest of the fund) and compensation schemes (*e.g.*, passing certain expenses<sup>618</sup> on to funds, which increases the adviser's revenue and decreases the fund's profits) that are contrary to the public interest and the protection of investors. In addition, adopting protective restrictions on these activities is reasonably designed to prevent fraud and deception.

Many of our concerns with these activities have persisted despite our related enforcement actions, and we believe therefore that further regulation is required. Investors often lack sufficient insight into the nature, scope, and impact of these activities, given that advisers do not frequently or consistently provide investors with sufficiently detailed information about them. In this regard, some commenters stated that many advisers do not provide disclosure of the activities covered by the restrictions and, when disclosure is provided about those activities, it is often incomplete or includes unhelpful information.<sup>619</sup> In addition, the limitations of private fund governance structures, discussed in detail above, warrant enhanced investor protection with

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<sup>616</sup> See MFA Comment Letter I.

<sup>617</sup> See Convergence Comment Letter; Invest Europe Comment Letter.

<sup>618</sup> See *supra* section I (discussing “reimbursements” as a form of “compensation”).

<sup>619</sup> See Healthy Markets Comment Letter I (stating that information is often unavailable or incomplete regarding these activities that may simply serve to enrich persons related to their investment advisers); ILPA Comment Letter I (stating that itemized disclosure of compliance costs is currently insufficient); NEBF Comment Letter (stating that it is difficult for investors to observe, track, and evaluate the costs and expenses that advisers shift to private funds); IFT Comment Letter (stating that some fund advisers have ignored requests for baseline information about fees and expenses).

respect to these activities.<sup>620</sup> For example, current private fund governance mechanisms, such as the LPAC, may not have sufficient independence, authority, or accountability to effectively oversee and consent to conflicts or other harmful practices.

After considering comments, and for the reasons discussed below in connection with each restricted activity, we have determined that investors will be better informed and receive enhanced protection, while still potentially benefiting from these activities when they are carried out in the best interests of the fund, if investors are provided with disclosures and, in some cases, consent rights regarding these activities. Accordingly, the final rule generally will provide either a disclosure-based exception or a disclosure- and consent-based exception for each restricted activity. The non-pro rata restriction will be subject to a before-the-fact disclosure-based exception (in addition to the requirement that the allocation be fair and reasonable), while the certain fees and expenses restrictions and the post-tax clawback restriction will be subject to after-the-fact disclosure-based exceptions. The borrowing restriction and the investigation restriction will be subject to a consent-based exception, which will require an adviser to receive advance consent from at least a majority in interest of a fund's investors in order to engage in these activities.<sup>621</sup> Specifically, each consent-based exception will require an adviser to seek consent for the restricted activity from all of the fund's investors and obtain consent from at least a majority in interest of investors that are not related persons of the adviser.<sup>622</sup> A fund's governing documents may establish that a higher threshold of investor consent is necessary in

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<sup>620</sup> See *supra* section I.A.

<sup>621</sup> However, the exception for the investigation restriction does not apply to 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 Act or the rules promulgated thereunder.

<sup>622</sup> With respect to a private fund whose investors are solely related persons of the fund's adviser, such as an internal fund whose investors are limited to the adviser's employees, the requirement in the consent-based exceptions to seek and obtain consent from non-related person investors will not apply.

order for the adviser to engage in these restricted activities and may generally prescribe the manner and process by which the applicable threshold of investor consent is obtained.<sup>623</sup>

However, in light of the limitations posed by fund governance bodies, such as LPACs, advisory boards, or boards of directors, which do not generally have a fiduciary obligation to the private fund investors, as discussed above,<sup>624</sup> the consent-based exceptions will require that the relevant consent be sought and obtained specifically from fund investors.

In light of this change from the proposal to allow an adviser to satisfy disclosure and, in some cases, consent requirements, as applicable, instead of being prohibited from certain activities, we are amending rule 204-2 under the Advisers Act to require SEC-registered investment advisers to retain books and records to document their compliance with the disclosure and consent aspects, as applicable of the restricted activities rule. This will help facilitate the Commission's inspection and enforcement capabilities. Accordingly, we are requiring SEC-registered investment advisers to retain a copy of any notification, consent, or other document distributed to or received from private fund investors pursuant to this rule, along with a record of each addressee and the corresponding date(s) sent for each such document distributed by the adviser.<sup>625</sup> Similarly, in a change from the proposal, we are not requiring private fund advisers to make and retain records of the addresses or delivery methods used to disseminate any such notifications or other documents distributed to private fund investors pursuant to this rule.<sup>626</sup>

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<sup>623</sup> For instance, the terms of a fund's governing documents may provide for the issuance of both voting and non-voting interests, where the non-voting interests are generally excluded for purposes of constituting a majority in interest (or a higher threshold) of investors. The fund's governing documents may also provide for the exclusion of defaulting investors for voting purposes.

<sup>624</sup> *See supra* section I.A.

<sup>625</sup> *See* final amended rule 204-2(a)(24).

<sup>626</sup> *See* the discussion of recordkeeping requirements above in section II.B.6.

The exceptions require advisers to “distribute” certain written notices or consent requests to investors.<sup>627</sup> An adviser generally will satisfy the requirement to “distribute” a written notice or consent request when it has been sent to all investors in the private fund. However, 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.<sup>628</sup> In circumstances where an investor is itself a pooled vehicle that is controlling, controlled by, or under common control (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) 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.” This approach will lead to meaningful distribution of the written notices and consent requests to the private fund’s investors.

In addition, the disclosure-based exceptions to the restrictions on certain regulatory, compliance, and examination fees and expenses and post-tax clawbacks require advisers to distribute written notices to investors within 45 days after the end of the fiscal quarter in which the relevant activity occurs. This disclosure timeline is appropriate because it emphasizes the need for the notices to be distributed to investors within a reasonable period of time to help ensure their timeliness, while affording advisers a limited degree of flexibility. The 45-day

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<sup>627</sup> See *supra* footnote 435 (discussing electronic delivery).

<sup>628</sup> See final rule 211(h)(1)-1. See *supra* section II.B.3 (“Preparation and Distribution of Quarterly Statements”) for a discussion of the “distribution” requirement generally.



timeline generally matches the timeline required for advisers to distribute quarterly statements under the quarterly statement rule, except for quarterly statements distributed at fiscal year-end or quarterly statements prepared for a fund of funds. This will allow advisers that are subject to the quarterly statement rule to include disclosures related to the restricted activities rule in their quarterly reports, subject to those exceptions.

## **1. Restricted Activities with Disclosure-Based Exceptions**

### **a) Regulatory, Compliance, and Examination Expenses**

We proposed to prohibit advisers from charging their private fund clients 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. We are adopting these provisions<sup>629</sup> but, after considering comments, are providing an exception from the proposed prohibitions if an adviser distributes a written notice of any such fees or expenses, and the dollar amount thereof,<sup>630</sup> to investors in a private fund in writing on at least a quarterly basis.<sup>631</sup>

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<sup>629</sup> In a change from the proposal, we are revising this requirement to capture not only amounts “charged” to the private fund but also fees and expenses “allocated to” the private fund. We believe that this clarification is necessary in light of the various ways that a private fund may be caused to bear fees and expenses.

<sup>630</sup> Such a written notice should generally include a detailed accounting of each category of such 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.”

<sup>631</sup> Final rule 211(h)(2)-1(a)(2). We are also reiterating that charging these expenses without authority in the governing documents is inconsistent with an adviser’s fiduciary duty. See the introduction of this section II.E above for a discussion of the distribution requirement. Advisers may, but are not required to, provide such disclosure in the statements they must deliver to investors under the quarterly statement rule, if they are subject to that rule. Although we generally do not consider information in the quarterly statement required by the rule to be an “advertisement” under the marketing rule, an adviser that offers new or additional investment advisory services with regard to securities in the quarterly statement would need to consider whether such information is subject to the marketing rule. A communication to a current investor is an “advertisement” when it offers new or additional investment advisory services with regard to securities. See rule 206(4)-1.

Some commenters supported the proposed prohibition, stating that advisers should not be charging examination, regulatory, and compliance fees and expenses to the fund.<sup>632</sup> Other commenters stated that this prohibition is unnecessary, at least in part because investors already negotiate what fees may or may not be charged to funds.<sup>633</sup> A number of commenters suggested that we should require disclosure of these expenses instead of prohibiting these practices.<sup>634</sup> In particular, as an alternative to the proposed prohibition, one commenter recommended that any such expenses should be fully disclosed to investors as separate line items<sup>635</sup> while another commenter recommended that we should require clear empirical disclosure of such expenses.<sup>636</sup> Some commenters argued that the proposed prohibition would harm investors because it would disincentivize advisers from investing in compliance.<sup>637</sup> Another commenter argued that compliance costs increase with diversification of an adviser's portfolio, and that requiring

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<sup>632</sup> See, e.g., AFR Comment Letter I; OPERS Comment Letter; NY State Comptroller Comment Letter.

<sup>633</sup> See, e.g., Sullivan and Cromwell LLP Comment Letter (Apr. 25, 2022) ("Sullivan & Cromwell Comment Letter"); NYC Bar Comment Letter II; ASA Comment Letter. One commenter stated that this prohibition is unnecessary because there is strong alignment of interests between advisers and investors with respect to regulatory, compliance, and examination-related expenses. This commenter noted that investments from principals and employees of its adviser account for over 20% of total assets under management and that these principals and employees pay the same fees and expenses as third-party investors. See Citadel Comment Letter. However, this is just one example and we understand that different private fund advisers have different alignments of interests with their investors depending on the amount of proprietary capital invested in the funds, fee arrangements, and other factors. Moreover, this commenter's argument does not address whether the private fund should be charged for the fees and expenses in the first place; rather, it focuses on the fact that certain advisers, especially advisers with significant investments in their private funds, have an incentive to limit such fees and expenses because they have the potential to reduce the adviser's returns alongside the investors' returns.

<sup>634</sup> See, e.g., Schulte Comment Letter; AIMA/ACC Comment Letter; SBAI Comment Letter. One commenter suggested that, to the extent no management fees are charged, disclosure and approval by the governing body for that private fund may be a more appropriate avenue in ensuring the expenses passed on are appropriate. See Albourne Comment Letter. We believe it is more appropriate to require disclosure to investors as private fund governing bodies can vary considerably in structure, representation and legal responsibility.

<sup>635</sup> See SBAI Comment Letter.

<sup>636</sup> See NYC Bar Comment Letter II.

<sup>637</sup> See, e.g., NVCA Comment Letter; Chamber of Commerce Comment Letter; Comment Letter of Andrew M. Weiss, Professor Emeritus, Boston University, Chief Executive Officer, Weiss Asset Management (Apr. 23, 2022) ("Weiss Comment Letter").

advisers to bear costs of compliance would therefore discourage portfolio diversification (and remove the ability for investors to decide for themselves whether they are willing to pay extra compliance costs to achieve better diversification).<sup>638</sup> Others predicted that advisers would assess higher management fees if they could not allocate these fees and expenses to funds.<sup>639</sup>

It is in investors' best interest for advisers to develop robust regulatory and compliance programs that enable advisers to comply with their legal and regulatory obligations. Regulatory, compliance, and examination fees and expenses are customary costs of doing business that enable advisers to operate and attract clients as well as investors. For example, advisers may incur filing and other fees associated with SEC filings, such as Form ADV and Form PF, as well as certain state filings. Advisers may also pay fees and expenses for a compliance consultant to help them with mock or real examinations. Most private fund advisers charge management fees, in part, to pay for costs incurred as a result of legal and regulatory obligations imposed on them in connection with providing advisory services. These and other costs of doing business are integral to managing a private fund and are generally considered overhead payable by the adviser out of its own resources. Charging investors separately for regulatory or compliance fees and expenses of the adviser or its related persons, or fees and expenses associated with an examination of the adviser or its related persons by any governmental or regulatory authority, is therefore a compensation scheme contrary to the public interest and protection of investors because an investment adviser, despite the management fees, is taking additional compensation for these fees and expenses.<sup>640</sup> Moreover, such allocations create a conflict of interest because

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<sup>638</sup> Comment Letter of Eric S. Maskin, Professor of Economics, Harvard University (Apr. 21, 2022) ("Maskin Comment Letter").

<sup>639</sup> *See, e.g.*, Dechert Comment Letter; Haynes & Boone Comment Letter; Chamber of Commerce Comment Letter.

<sup>640</sup> *See supra* section I for a discussion of the definition of "compensation scheme".

they provide an incentive for an adviser to place its own interests ahead of the private fund's interests and allocate expenses away from the adviser to the fund.<sup>641</sup> We also believe that allocation of these types of fees and expenses to private fund clients can be deceptive in current market practice. For example, investors may generally expect an adviser to bear fees and expenses directly related to its advisory business, similar to how investors typically bear fees and expenses directly related to their own investment activity. Further, while certain investors may 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.<sup>642</sup> Restrictions on the charging of these fees and expenses are, therefore, merited.

The requirement to disclose these charges for regulatory, compliance, and examination fees and expenses within 45 days after the end of the fiscal quarter is also appropriate. This timeline emphasizes the need for the notices to be distributed to investors within a reasonable period of time to help ensure their timeliness, while affording advisers a limited degree of flexibility. The 45-day timeline generally matches the timeline required for advisers to distribute quarterly statements under the quarterly statement rule, except for quarterly statements distributed at fiscal year-end or quarterly statements prepared for a fund of funds. This structure will allow advisers that are subject to the quarterly statement rule to generally include disclosures related to the restricted activities rule in their quarterly reports, subject to those exceptions.

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<sup>641</sup> See, e.g., *In the Matter of NB Alternatives Advisers*, *supra* footnote 29 (alleging private fund adviser allocated employee compensation-related expenses to three private equity funds it advised in violation of their organizational documents).

<sup>642</sup> For example, if an adviser charges a fund for fees and expenses associated with the preparation and filing of the adviser's Form ADV but only identifies such charges broadly as "legal expenses."

After reviewing responses from commenters, we acknowledge that a prohibition of certain of these charges without an exception for instances in which the adviser provides effective disclosure could result in unfavorable outcomes for investors. For example, as some commenters also suggested,<sup>643</sup> we anticipate that some advisers may be disincentivized from diversifying their portfolios to the extent that compliance costs (that will now be borne by the adviser) increase with portfolio diversification. As other commenters also stated,<sup>644</sup> 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 may have been more than the increase in any fees or expenses already being passed through to the private fund. We also recognize that whether such fees and expenses can be charged to the private fund can be highly negotiated by investors in certain instances<sup>645</sup> (*e.g.*, investors may be more receptive to bearing registration and other compliance expenses for a first-time manager).<sup>646</sup> As a result, we believe it is necessary to prohibit these practices unless advisers distribute written notice of any such fees or expenses, and the dollar amount thereof, to investors in any such private funds in writing on at least a quarterly basis. In short, advisers must notify investors of such actual allocation practices on a regular, ongoing basis to help ensure that investors are able to negotiate

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<sup>643</sup> See, *e.g.*, Chamber of Commerce Comment Letter; Weiss Comment Letter; Maskin Comment Letter.

<sup>644</sup> See, *e.g.*, Dechert Comment Letter; Haynes & Boone Comment Letter; Chamber of Commerce Comment Letter.

<sup>645</sup> However, even in such circumstances where fee and expense allocation provisions are highly negotiated, we believe such negotiation is only effective if investors are receiving timely and detailed disclosure of any such allocations when they occur.

<sup>646</sup> Some commenters also stated that the proposed prohibition would put underrepresented private fund advisers, such as those advisers that are minority-owned, at a disadvantage when competing with more established firms that can waive fees for services. See, *e.g.*, Blended Impact Comment Letter; CozDev LLC Comment Letter; BAM Ventures Comment Letter.

effectively for their own interests and avoid the compensation schemes that are contrary to the public interest and the protection of investors.

To illustrate, an adviser may charge a private fund client for fees it pays to a compliance consultant to assess the adviser's compliance program, provided the adviser discloses those fees pursuant to this rule. An adviser may also charge a private fund client for fees and expenses associated with an examination of the adviser or its related persons, such as by staff from our Division of Examinations, provided those fees and expenses are adequately disclosed pursuant to this rule.

Some commenters expressed concerns about how the proposed prohibition would adversely impact funds with “pass-through” expense models.<sup>647</sup> Since we are providing a disclosure-based exception from this prohibition, we no longer anticipate that this aspect of the proposed prohibited activities rule will cause a significant disruption in practice for funds with pass-through expense models. We understand that most pass-through funds already provide ongoing, regular disclosure of the fees and expenses that are being “passed through” to investors.

Some commenters suggested that we should explicitly clarify which compliance fees and expenses are related to the adviser's activities or the fund's activities.<sup>648</sup> As we are not flatly prohibiting advisers from passing on compliance, regulatory, and examination expenses, we do not believe it is necessary to describe which fees and expenses are related to the adviser's activities or the fund's activities. Advisers and investors may negotiate whether certain

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<sup>647</sup> Certain private fund advisers utilize a pass-through expense model where the private fund pays for most, if not all, expenses, including the adviser's expenses, but the adviser does not charge a management, advisory, or similar fee. *See, e.g.*, BVCA Comment Letter; Sullivan & Cromwell Comment Letter; SBAI Comment Letter.

<sup>648</sup> *See, e.g.*, NSCP Comment Letter; NYC Bar Comment Letter II; Ropes & Gray Comment Letter.

compliance, regulatory, or examination fees and expenses are charged to a fund, provided that the disclosure of such fees and expenses satisfies the requirements of the rule.

## **b) Reducing Adviser Clawbacks for Taxes**

We proposed to prohibit an adviser from reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.<sup>649</sup> This proposed provision was designed to protect investors by ensuring that they receive their share of fund profits, without any reduction for tax obligations of the adviser or its related persons.<sup>650</sup> However, as discussed further below, the final rule will not prohibit advisers from engaging in after-tax adviser clawback reductions, if advisers satisfy certain disclosure requirements designed to better inform private fund investors of the impact of after-tax adviser clawback reductions.<sup>651</sup>

Some commenters supported the proposal to prohibit advisers from reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes.<sup>652</sup> Some also encouraged the

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<sup>649</sup> The proposed rule defined: (i) “adviser clawback” as any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund’s governing agreements, and (ii) “performance-based compensation” as allocations, payments, or distributions of capital based on the private fund’s (or its portfolio investments’) capital gains and/or capital appreciation. Commenters generally did not provide comments with respect to the proposed definitions of “adviser clawback” and “performance-based compensation.” We are adopting the definition of “adviser clawback” as proposed. However, in a change from the proposed rule, we are making a technical revision to the “performance-based compensation” definition to include allocations, payments, or distributions of profit. *See supra* section II.B.1.a. *See also* final rule 211(h)(1)-1.

<sup>650</sup> *See* Proposing Release, *supra* footnote 3, at 146-147.

<sup>651</sup> For the avoidance of doubt, the rule does not change the applicability to the adviser of any other applicable disclosure and consent obligation, whether they exist under law, rule, regulation, contract, or otherwise.

<sup>652</sup> *See, e.g.*, AFL-CIO Comment Letter; Albourne Comment Letter; Better Markets Comment Letter; Convergence Comment Letter; NASAA Comment Letter; NYC Comptroller Comment Letter; OPERS Comment Letter; Predistribution Initiative Comment Letter II; Comment Letter of Reinhart Boerner Van Deuren (Apr. 12, 2022) (“Reinhart Comment Letter”); RFG Comment Letter II. Because many entities that receive performance-based compensation are fiscally transparent for U.S. Federal income tax purposes and thus not subject to entity-level taxes, determining the actual taxes paid on “excess” performance-based compensation can be challenging, particularly for larger advisers that have not only a significant number of

Commission to expand the scope of the rule to require advisers to provide affirmatively, whether in the governing agreement or otherwise, a clawback mechanism to restore excess performance-based compensation, rather than only prohibiting advisers from reducing clawbacks by taxes applicable to the adviser.<sup>653</sup>

The majority of commenters, however, opposed this aspect of the proposal. Many commenters suggested that our proposal was unnecessary to ensure that private fund investors receive their full share of fund profits, because clawback mechanisms are structured to restore private funds with the full amount of any excess performance-based compensation received by the adviser (or its related persons), except in the rare circumstances where such excess amount is so significant as to be greater than the total amount of performance-based compensation retained by the adviser (or its related persons) on an after-tax basis.<sup>654</sup> These commenters suggested that post-tax clawbacks reflect a widely accepted and negotiated position between advisers and their private fund clients (and, indirectly, their private fund investors).<sup>655</sup> They stated that the prevailing market practice is to allocate the economic risk of a post-tax clawback to private fund clients, rather than to advisers, because if this economic risk were allocated to advisers, it could leave them worse off than if they had not received any performance-based compensation at all.<sup>656</sup>

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participants that receive such compensation but also have participants subject to non-U.S. tax regimes. Moreover, investors may be in different U.S. States as well, each with their State tax nuances. To address these considerations, advisers typically use a “hypothetical marginal tax rate” to determine the tax reduction amount, which is usually based on the highest marginal U.S. Federal, State, and local tax rates.

<sup>653</sup> See NACUBO Comment Letter; Reinhart Comment Letter.

<sup>654</sup> See, e.g., AIC Comment Letter I; Dechert Comment Letter; Ropes & Gray Comment Letter.

<sup>655</sup> See, e.g., AIC Comment Letter I; AIMA/ACC Comment Letter; ASA Comment Letter; Comment Letter of Baird Capital (Apr. 25, 2022) (“Baird Comment Letter”); Carta Comment Letter; IAA Comment Letter II; Comment Letter of PROOF Management, LLC (May 25, 2022) (“Proof Comment Letter”); Ropes & Gray Comment Letter.

<sup>656</sup> See, e.g., AIC Comment Letter I; Baird Comment Letter; GPEVCA Comment Letter; IAA Comment Letter II; Invest Europe Comment Letter; Comment Letter of National Association of Private Fund Managers (Apr. 25, 2022); Proof Comment Letter; Ropes & Gray Comment Letter.



These commenters stated that advisers could be worse off because taxes paid in respect of excess performance-based compensation generally cannot be recouped by amending prior tax returns, and the ability to realize a tax benefit from subsequent losses is in practice limited. Additionally, these commenters indicated that both applicable tax rules and portfolio management considerations (such as determining at what time the disposal of a portfolio investment would be in a private fund client's best economic interest) limit the actual discretion that advisers otherwise might have to defer or delay payments of performance-based compensation to prevent the need for a clawback.<sup>657</sup> For example, because U.S. tax laws require a partner of a partnership to pay annual tax based on the amount of partnership income allocated to the partner, rather than based on the amount of actual partnership distributions received by the partner in the applicable year, an adviser may not necessarily be in a position to delay or defer payments or allocations of performance-based compensation to prevent the need for a clawback.

We believe that reducing the amount of any adviser clawback by taxes applicable to the adviser presents an opportunity for an adviser to put its own interests ahead of its clients' interests by allocating to the client (and indirectly, to fund investors) the risk of a tax liability otherwise attributable to and borne by the adviser, which reduces its client's (and indirectly, fund investors') returns. We therefore believe that, unless this practice is adequately disclosed to investors, it creates a compensation scheme that is contrary to the public interest and the protection of investors.<sup>658</sup> Furthermore, although investors may contractually agree, per a fund's

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<sup>657</sup> See, e.g., AIC Comment Letter I; GPEVCA Comment Letter; Dechert Comment Letter; IAA Comment Letter II; Invest Europe Comment Letter; Proof Comment Letter; Ropes & Gray Comment Letter; SIFMA-AMG Comment Letter I.

<sup>658</sup> The after-tax reduction of an adviser clawback constitutes a compensation scheme within the meaning of section 211(h) of the Advisers Act because it is a method by which an investment adviser may take additional compensation indirectly that otherwise its private fund clients would be entitled to as investment proceeds.

governing documents and with appropriate initial disclosure, to an adviser's ability to reduce an adviser clawback by applicable taxes, investors may be deceived to the extent that an adviser does not disclose information relating to the total dollar amount of the adviser clawback and its reduction after the fact.<sup>659</sup> To the extent that their private fund investments are opaque, investors can lack insight into this potentially conflicted practice by advisers and its impact on the returns of their private fund investments.

We appreciate commenters' concerns that the proposed rule could ultimately result in unintended consequences that would be inconsistent with our proposal's purpose, such as, among others, the following: fewer advisers choosing to offer clawback mechanisms in their private funds when such mechanisms benefit investors; restructuring performance-based compensation arrangements in a way that would be less favorable for investors (*e.g.*, adopting incentive fee structures that reduce or eliminate the potential for a clawback but are less favorable to certain investors from a tax treatment perspective, or implementing higher carried interest rates); offsetting changes to other economic terms applicable to investors (*e.g.*, implementing higher management fees); adjusting the timing of portfolio management decisions to avoid potential clawback liabilities (*i.e.*, potentially incentivizing advisers to make portfolio management decisions for reasons other than a private fund client's best interests); and disproportionate burdens on smaller investment advisers that may be more reliant on the receipt of performance-based compensation on a deal-by-deal basis to remunerate their employees and fund their

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<sup>659</sup> Cf. Form PF; Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers; Requirements for Large Private Equity Fund Adviser Reporting, Investment Advisers Act Release No. 6279 (May 3, 2023) [88 FR 38146 (June 12, 2023)], at 73-74 (discussing conflicts of interest that may arise from general and limited partner clawbacks and noting that "clawbacks are negotiated early on in a fund's life, long before the inciting event occurs").

operations.<sup>660</sup> In view of these potential unintended consequences, several commenters suggested that the Commission adopt disclosure requirements relating to the use of after-tax adviser clawbacks rather than an outright prohibition of the practice,<sup>661</sup> and we agree, as described below.

Many investors lack information regarding adviser clawbacks and their impact on fund profits. For example, many fund agreements only require advisers to restore the excess performance-based compensation (less taxes) to the fund, without requiring them to provide investors with any information regarding the adviser's related determinations and calculations, such as whether a clawback was triggered and the aggregate amount of the clawback. Without adequate disclosure, investors are unable to understand and assess the magnitude and scope of the clawback, as well as its impact on fund performance and investor returns. Further, not all investors may be able to ask questions successfully or seek more information about a clawback on a voluntary basis from their private fund's adviser. We believe that disclosure will achieve

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<sup>660</sup> See, e.g., AIC Comment Letter I; AIC Comment Letter II; AIMA/ACC Comment Letter; ATR Comment Letter; CCMR Comment Letter I; Comment Letter of Correlation Ventures (June 13, 2022) ("Correlation Ventures Comment Letter"); Comment Letter of Canadian Venture Capital and Private Equity Association (Apr. 25, 2022) ("CVCA Comment Letter"); Comment Letter of Landspire Group (Apr. 25, 2022); Lockstep Ventures Comment Letter; Comment Letter of the National Association of Investment Companies (Apr. 25, 2022) ("NAIC Comment Letter"); PIFF Comment Letter; Proof Comment Letter; Ropes & Gray Comment Letter; SBAI Comment Letter; Schulte Comment Letter; SIFMA-AMG Comment Letter I; Comment Letter of Top Tier Capital Partners, LLC (June 13, 2022) ("Top Tier Comment Letter").

<sup>661</sup> See NVCA Comment Letter (stating that the Commission should consider the alternative of using enhanced disclosures instead of banning clawback reduction provisions); Comment Letter of OPSEU Pension Plan Trust (Aug. 18, 2022) (stating that investment terms are a negotiation between advisers and institutional investors and that the final rules should generally focus on disclosure rather than prohibitions); SIFMA-AMG Comment Letter I (stating that, if adopted, the final rule should require advisers to include estimated clawback calculations reflecting any adjustments for taxes as part of the quarterly statement reporting requirements, which would enable investors to assess a potential clawback situation and any potential reductions for taxes, that may arise); AIC Comment Letter I (stating that, if adopted, the final rule should require only quarterly disclosures to private fund investors of the potential clawback payable and the amount of carried interest distributions that have been reserved against the potential clawback).

the rule's policy goal of protecting investors, while preventing unintended consequences that may have resulted from a flat prohibition.

Accordingly, the final rule will not prohibit advisers from engaging in after-tax adviser clawback reductions, if advisers satisfy certain disclosure requirements designed to better inform private fund investors of the impact of after-tax adviser clawback reductions.<sup>662</sup> Specifically, the final rule restricts advisers from reducing the amount of an adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders, unless the adviser distributes a written notice to the investors of the impacted private fund client that sets forth the aggregate dollar amounts of the adviser clawback both before and after any such reduction of the clawback for actual, potential, or hypothetical taxes within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.<sup>663</sup>

In order to satisfy the disclosure requirement, 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 affected private fund client 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. The aggregate dollar amount of the clawback before the application of any tax reductions must not be reduced by taxes paid, or deemed paid, by the recipients or other persons on their behalf, whereas the aggregate dollar amount of the clawback after the application of any tax reduction needs to be so reduced. As an example of disclosure that an adviser can make to satisfy this requirement, an adviser that is subject to a clawback

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<sup>662</sup> For the avoidance of doubt, this does not change the applicability to the adviser of any other applicable disclosure and consent obligations, whether they exist under law, rule, regulation, contract, or otherwise.

<sup>663</sup> See final rule 211(h)(2)-1(a)(3).

could at the end of a private fund's term include disclosure in the fund's quarterly statement regarding the aggregate dollar amounts of the adviser clawback before and after the application of any tax reduction (if the adviser is subject to the quarterly statement requirement and to the extent that the quarterly statement is delivered within 45 days following the end of the relevant fiscal quarter). An investor will be able to compare these reported aggregate dollar amounts of the adviser clawback both before and after any tax reduction to evaluate the actual impact of a tax reduction on the clawback.

An investment adviser may wish to consider providing private fund client investors with, and investors may request and negotiate for, additional information that is not specifically required by the final rule. For example, advisers that routinely monitor their potential clawback liability could provide their private fund client investors with information regarding their currently estimated clawback amounts.<sup>664</sup> Additionally, in situations where an adviser's tax reduction serves to reduce the clawback amount received by a private fund client, an adviser could consider providing investors in such fund with information clarifying their respective shares of the reduction.

### **c) Certain Non-Pro Rata Fee and Expense Allocations**

We proposed to prohibit an adviser from directly or indirectly charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related

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<sup>664</sup> One commenter stated that, if adopted, the final rule should require advisers to include estimated clawback calculations reflecting any adjustments for taxes as part of the quarterly statement reporting requirements, which would enable investors to assess a potential clawback situation, and any potential reductions for taxes, that may arise. *See* SIFMA-AMG Comment Letter I. Including such information in the quarterly statement is not necessary to satisfy the specific disclosure requirements and transparency objectives of the final restrictions rule.

persons have invested (or propose to invest) in the same portfolio investment.<sup>665</sup> Charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment presents an opportunity for an adviser to put its interests ahead of its clients' interests (and, by extension, their investors'), and can result in private funds and their investors, particularly smaller investors that may not have as much influence with the adviser or its related persons, being misled, deceived, or otherwise harmed. As discussed in greater detail below, any such non-pro rata charge or allocation can create a conflict of interest and operate as a compensation scheme, both of which we deem contrary to the public interest and the protection of investors.<sup>666</sup> This practice may also violate antifraud provisions if an adviser contravenes representations within the fund governing documents, and the adviser, faced with a conflict of interest, may seek to charge or allocate fees and expenses to one fund client as opposed to another client in a manner that benefits the adviser.<sup>667</sup> Despite the number of enforcement actions brought by the Commission, we believe that this practice still exists among private fund advisers. Accordingly, we believe it

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<sup>665</sup> Proposed rule 211(h)(2)-1(a)(6).

<sup>666</sup> *In the Matter of Energy Capital Partners*, *supra* footnote 30; *In the Matter of Rialto Capital Management, LLC*, *supra* footnote 222; *In the Matter of Lightyear Capital, LLC*, Investment Advisers Release No. 5096 (Dec. 26, 2018) (settled action); *In the Matter of WL Ross & Co. LLC*, Investment Advisers Act Release No. 4494 (Aug. 24, 2016) (settled action); *In the Matter of Kohlberg Kravis Roberts & Co.*, *supra* footnote 28; *In the Matter of Lincolnshire*, *supra* footnote 26; *see In the Matter of Platinum Equity Advisors, LLC*, Investment Advisers Release No. 4772 (Sept. 21, 2017) (settled action). Our staff has also observed instances of advisers charging or allocating fees and expenses related to a portfolio investment on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment during examinations. *See* EXAMS Private Funds Risk Alert 2020, *supra* footnote 188.

<sup>667</sup> *See, e.g., In the Matter of Platinum Equity Advisors, LLC*, *supra* footnote 666.

is appropriate to promulgate a rule that restricts it.<sup>668</sup> The adopted rule therefore restricts this practice unless (i) the non-pro rata charge or allocation is fair and equitable under the circumstances and (ii) prior to charging or allocating such fees or expenses to a private fund client, the investment adviser *distributes* to each investor of the private fund a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances.<sup>669</sup>

Charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis presents a conflict of interest because advisers have economic and/or other business reasons to charge or allocate fees and expenses to one fund client as opposed to another client (*e.g.*, differences in a private fund's fee structure, ownership structure, lifecycle, and investor base).<sup>670</sup> For example, when determining how to charge or allocate fees and expenses related to a portfolio investment where multiple private fund clients have invested (or propose to invest), the adviser may choose to charge or allocate less fees and expenses to its higher fee-paying client to the detriment of its lower fee-paying client because the higher fee-paying client pays more to the adviser. Not only would this decision to charge or allocate less fees and expenses to its higher fee-paying client benefit the adviser but it could also

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<sup>668</sup> See, *e.g.*, *In the Matter of Energy Capital Partners*, *supra* footnote 30; see also Healthy Markets Comment Letter I (stating that investors are very unlikely to be willing or able to negotiate on their own the end of these practices, such as charging certain non-pro-rata fees and expenses).

<sup>669</sup> Final rule 211(h)(2)-1(a)(4). In a change from the proposal, we are making a revision to the rule text to clarify that the prohibition is against charging either fees, or expenses, or both.

<sup>670</sup> In some instances, a fund may not have the resources to bear its pro rata share of expenses related to a portfolio investment (whether due to insufficient reserves, the inability to call capital to cover such expenses, or otherwise).

disadvantage the lower fee-paying client and its investors who bear more than a pro rata share of expenses while supporting the value of the higher fee-paying client's investment.<sup>671</sup>

We have observed these considerations leading advisers to favor one private fund client (and its investors) over another private fund client (and its investors) because of the fund's investor base. For example, as part of their strategy, some advisers agree to perform certain services, *e.g.*, asset-level due diligence, accounting, valuation, legal, either in-house or through a captive consulting firm, for portfolio investments at costs that are at or below market rates rather than hire a third party to perform these services.<sup>672</sup> To facilitate a portfolio investment, the adviser may set up a co-investment vehicle that invests alongside the adviser's main fund.<sup>673</sup> If the main fund and the co-investment vehicle have both invested (or propose to invest) in the same portfolio investment that engages the adviser for these services, the adviser may decide not to allocate the costs of these services to the co-investment vehicle, which is often made up of favored or larger investors and may have specific fee and expense limits, and may instead allocate the costs of these services to the main fund, causing the main fund to pay more in expenses than it otherwise would under a pro-rata allocation.

Charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment is a conflict of interest for the adviser and can also lead, and in our

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<sup>671</sup> The final rule does not prohibit an adviser from paying a fund's pro rata portion of any fee or expense with its own capital. In addition, to the extent a fund does not have resources to pay for its share, the final rule does not prohibit an adviser from diluting such fund's interest in the portfolio investment in a manner that is fair and equitable, subject to applicable laws, rules, or regulations and applicable provisions of the fund's governing documents.

<sup>672</sup> See, *e.g.*, *In the Matter of Rialto Capital Management, LLC*, *supra* footnote 222.

<sup>673</sup> *Id.*



experience often does lead, to a compensation scheme that we deem contrary to the public interest and protection of investors, unless this practice is fair and equitable and is adequately disclosed to investors in advance. It also may be fraudulent or deceptive, and result in investor harm. For instance, if two funds invest in the same portfolio investment but only one fund pays an incentive allocation, the adviser may have an incentive to avoid charging or allocating fees and expenses to the fund paying an incentive allocation in an effort to increase the adviser's incentive allocation. Similarly, if the adviser's ownership interests vary from fund to fund, the adviser may have an incentive to charge or allocate fees and expenses away from the fund in which the adviser holds a greater interest.<sup>674</sup> Because of these differences in ownership or compensation structures, an adviser may have an incentive to charge or allocate fees and expenses in a way that maximizes its economic entitlements at the expense of its fund client's (and investors') economic entitlements.

Moreover, this practice can result in a conflict of interest and compensation scheme contrary to the protection of investors by favoring not only the adviser but also the adviser's related persons. For example, an adviser may set up co-investment vehicles for related persons, such as executives, family members, and certain consultants, that invest alongside the adviser's main fund.<sup>675</sup> These co-investment vehicles may receive a set percentage of each portfolio investment made by the adviser's main fund without having to share in any research expenses, travel costs, professional fees, and other expenses incurred in deal sourcing activities related to portfolio investments that never materialize. For the adviser to allow its related persons, such as

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<sup>674</sup> Although the adviser's interest (or its affiliate's interest, such as the general partner's interest) may not be charged a management fee or an incentive allocation, they are often allocated or charged fund expenses, directly or indirectly, in a manner that is similar to a third party investor's interest in the fund.

<sup>675</sup> See, e.g., *In the Matter of Kohlberg Kravis Roberts & Co*, *supra* footnote 28.

executives, family, and certain consultants, to participate in consummated portfolio investments without having to bear the cost of these expenses may be an undisclosed form of compensation to the adviser and its related persons. It also may defraud, deceive, or harm the fund that bore the co-investment vehicle's share of expenses.

Some commenters supported the proposed prohibition and stated it would protect investors, including those who do not benefit from co-investment opportunities.<sup>676</sup> In contrast, other commenters opposed the proposed prohibition and stated that it could result in inequitable outcomes<sup>677</sup> and would be disruptive.<sup>678</sup> Commenters stated that allowing advisers to allocate expenses on a non-pro rata basis is essential for the fair treatment of investors because it allows advisers to allocate expenses appropriately to the relevant investors that generated the additional cost.<sup>679</sup> Commenters asserted that the prescriptive nature of the proposed rule would result in unintended consequences, indicating there may be circumstances, whether due to tax, regulatory, accounting, or other reasons, where a pro rata expense allocation would lead to inequitable results.<sup>680</sup> For example, they questioned whether the proposed rule would prevent an adviser from fairly allocating tax liabilities that are attributable to a specific investor in the private fund (*e.g.*, withholding taxes and partnership-level assessments resulting from a tax audit) and whether the adviser absorbing certain expenses of a specific investor where that investor is

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<sup>676</sup> See Healthy Markets Comment Letter I; NY State Comptroller Comment Letter; AFL-CIO Comment Letter; ILPA Comment Letter I; ICCR Comment Letter; RFG Comment Letter II. See also IAA Comment Letter II.

<sup>677</sup> See SBAI Comment Letter; IAA Comment Letter II; Ropes & Gray Comment Letter.

<sup>678</sup> See Dechert Comment Letter; AIC Comment Letter I; MFA Comment Letter I; NYC Bar Comment Letter II.

<sup>679</sup> See Dechert Comment Letter (discussing scenarios where a particular investment structure, tax structure and/or regulatory position or status for an investment exists solely to benefit one or more particular investors); Ropes & Gray Comment Letter.

<sup>680</sup> See Dechert Comment Letter.

unable to pay for the expense in the private fund would be seen as non-pro rata allocation under the proposed rule.<sup>681</sup>

Many commenters suggested that we instead allow advisers to allocate fees and expenses related to portfolio expenses in a fair and equitable manner. Some suggested that we refrain from rulemaking on this issue because advisers are already required to allocate fees and expenses on a fair and equitable basis,<sup>682</sup> while others urged the Commission to adopt an exception for non-pro rata fee and expense charges or allocations that are appropriately disclosed and consented to by investors<sup>683</sup> or an alternative approach that involves disclosure to investors to avoid unfair outcomes.<sup>684</sup> For example, some commenters suggested that, as an alternative to the proposed prohibition, advisers disclose their policies and procedures regarding the allocation of fees and expenses among private funds to each fund investor.<sup>685</sup> In another example, a commenter suggested that we should require disclosure only where fees and expenses are not split on a pro-rata basis.<sup>686</sup> One commenter stated that advisers typically allocate expenses on a pro rata basis, unless it would otherwise be fair and equitable to allocate non-pro rata under the circumstances.<sup>687</sup> This commenter suggested that a disclosure-based approach would afford

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<sup>681</sup> See Dechert Comment Letter; OPERS Comment Letter.

<sup>682</sup> See NYC Bar Comment Letter II; MFA Comment Letter I; Comment Letter of the Managed Funds Association (June 13, 2022) (“MFA Comment Letter II”).

<sup>683</sup> See Convergence Comment Letter; Invest Europe Comment Letter.

<sup>684</sup> See Comment Letter of the Securities Industry and Financial Markets Association Asset Management Group (June 13, 2022); GPEVCA Comment Letter; SIFMA-AMG Comment Letter I; SBAI Comment Letter; Ropes & Gray Comment Letter; AIMA/ACC Comment Letter.

<sup>685</sup> See IAA Comment Letter II; *see generally* NY State Comptroller Comment Letter (suggesting the disclosure of written expense allocation and control policies to investors).

<sup>686</sup> See SBAI Comment Letter.

<sup>687</sup> See GPEVCA Comment Letter.

more flexibility and accommodate the diversity of investment structures used by advisers for private funds.

After considering comments, we are adopting a rule that focuses on ensuring that clients are treated fairly and equitably, which we recognize may not always mean clients must be treated identically. Accordingly, in a change from the proposal, the final rule prohibits a private fund adviser from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis, unless the adviser meets two requirements.<sup>688</sup>

First, the adviser's non-pro rata allocation must be fair and equitable under the circumstances. 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 client holds. In another example, a factor could be whether the expense relates to a bespoke structuring arrangement for one private fund client to participate in the portfolio investment. As yet another example, another factor could be that one private fund client may receive a greater benefit from the expense relative to other private fund clients, such as the potential benefit of certain insurance policies.

Second, before charging or allocating such fees or expenses to a private fund client, 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. The written notice will allow an investor to understand better how the adviser is treating the private fund relative to other private funds or clients advised by the adviser. For instance, the written notice may help the investor understand whether the adviser's allocation approach creates any conflicts of

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<sup>688</sup> Final rule 211(h)(2)-1(a)(4).

interest, results in any additional direct or indirect compensation to the adviser or its related parties, creates the risk of potential harms, or results in other disadvantages related to such activity. In this notice, advisers should consider addressing relevant factors, which might include the adviser's allocation approach and the reason(s) why the adviser believes that its non-pro rata allocation approach is fair and equitable under the circumstances. This change is responsive to comments that we received suggesting that adviser's allocations are or should be fair and equitable<sup>689</sup> and that a more disclosure-based approach in certain instances rather than a strict requirement to charge or allocate fees and expenses solely on a pro rata basis.<sup>690</sup> This disclosure setting forth how the adviser's allocation is fair and equitable must be distributed to all investors in the private fund.

We believe that it is important for all investors in the private fund to receive this disclosure before the adviser charges or allocates non-pro rata fees or expenses to a private fund client. Private fund investors generally do not have insight into (and the quarterly statement rule will not require advisers to disclose) the amounts of joint fees or expenses that the adviser allocated to its other clients, and investors are unable to compare amounts borne by their fund with amounts borne by the adviser's other clients to assess whether the adviser allocated joint costs consistently with the fund's terms and other disclosures and representations made by the adviser. To make this assessment, an investor would need access to information regarding the terms of the adviser's relationships with its clients other than the fund, as well as certain

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<sup>689</sup> GPEVCA Comment Letter; NYC Bar Comment Letter II; MFA Comment Letter I; MFA Comment Letter II.

<sup>690</sup> See SIFMA-AMG Comment Letter I; GPEVCA Comment Letter; SBAI Comment Letter. *See generally* IAA Comment Letter II (suggesting the disclosure of written fee and expense allocation policies to investors); NY State Comptroller Comment Letter (suggesting the disclosure of written expense allocation and control policies to investors).

information (including potentially accounting information) about those other clients. This advance disclosure timeline therefore is appropriate because it provides investors with access to important fee and expense information to enable investors to discuss the non-pro rata allocation with the adviser before being charged.

As explained above, we believe it is important to restrict the practice of charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis because this practice presents a conflict of interest and can result in a compensation scheme that is contrary to the public interest and the protection of investors. We have not, however, prohibited this practice where an adviser's non-pro rata allocation would be fair and equitable under the circumstances. We recognize that private fund advisers may structure investments for specific tax, regulatory, accounting, or other reasons for the benefit of certain investors, creating a diversity of investment structures. We believe this framework offers investors additional protections while simultaneously offering advisers the flexibility to execute investment strategies and offer a diversity of investment structures in a way that may benefit investors.

This framework will also encourage advisers, as fiduciaries, to review their approach to allocating fees and expenses to their clients, particularly if advisers must disclose to investors why an allocation is fair and equitable. This framework provides more comprehensive information for investors so that investors can evaluate the adviser's allocation approach.

Several commenters, including a commenter that generally supported this rule, expressed concern that the proposed rule could impair co-investment opportunities.<sup>691</sup> They stated that co-

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<sup>691</sup> See Schulte Comment Letter; OPERS Comment Letter; PIFF Comment Letter; AIC Comment Letter I; Ropes & Gray Comment Letter; BVCA Comment Letter; Invest Europe Comment Letter; Dechert Comment Letter; GPEVCA Comment Letter. See also ILPA Comment Letter I.

investment opportunities benefit the fund and its investors, and that such transactions are critical to enabling the fund to execute its investment strategy.<sup>692</sup> Commenters suggested that the proposed rule would severely impact the availability of co-investment opportunities because these are time-sensitive opportunities and increasing the regulatory burden on advisers would only heighten the chance that private funds would miss out on an opportunity to participate.<sup>693</sup> They also stated that the rule would interrupt the commercial speed of co-investment transactions because potential co-investors would wait until a transaction is certain before committing to the transaction to avoid broken deal expenses.<sup>694</sup> Also, these commenters expressed concern that advisers could lack the leverage necessary to require co-investors to share in fees and expenses on a pro rata basis and that some co-investors may decline to participate in the transaction rather than bear additional fees and expenses. These commenters asserted that the rule would inhibit capital formation by preventing funds from completing larger deals because they would not be able to find co-investment capital to invest alongside the fund. Because the final rule restricts (rather than prohibits) this practice if the adviser makes certain disclosures, we believe the final rule generally addresses these concerns. For example, although we acknowledge that many co-investments are executed on short notice, co-investors typically review and negotiate co-investment documentation, such as fund agreements, side letters, and subscription agreements, prior to the closing of the transaction. We believe that the final rule's requirements can generally be completed during this period (and prior to the adviser completing the non-pro rata charge or allocation). We believe restricting this practice while requiring disclosure and that it be fair and

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<sup>692</sup> See Schulte Comment Letter; OPERS Comment Letter.

<sup>693</sup> See Schulte Comment Letter; PIFF Comment Letter.

<sup>694</sup> See AIC Comment Letter I; Ropes & Gray Comment Letter.

equitable balances the burdens on the adviser with the interests of investors to be treated fairly and receive timely access to important information about non-pro rata fee and expense allocations. While we acknowledge that this approach imposes some incremental burden on co-investment deals, we do not believe the burdens created by these requirements will significantly deter investor appetite for co-investments or inhibit capital formation.<sup>695</sup>

We requested comment on whether we should define “pro rata.” In the past, we have generally observed that advisers implement pro rata allocations based on ownership percentages.<sup>696</sup> For example, one adviser allocated a fund more than its pro rata share of bridge facility commitment fees relative to its ownership of a portfolio investment.<sup>697</sup> In another example, a co-investment vehicle’s governing documents provided that the co-investment vehicle would pay its pro rata share of expenses for any portfolio company investments made by the co-investment vehicle.<sup>698</sup> Although the co-investment vehicle agreed to pay its pro rata share of expenses of any consummated portfolio company investment and the co-investment vehicle invested on a predetermined amount in each consummated portfolio company investment, the adviser did not allocate broken deal expenses to the co-investment vehicles.<sup>699</sup> We have alleged in settled enforcement actions that an adviser has allocated transaction fees in a way that

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<sup>695</sup> See *infra* section VI.E.3 (where we discuss several factors that may mitigate these potentially negative effects, including reasons why the disclosure requirements could promote capital formation).

<sup>696</sup> See *In the Matter of Energy Capital Partners*, *supra* footnote 30; *In the Matter of Platinum Equity Advisors, LLC*, *supra* footnote 666; *In the Matter of WL Ross & Co. LLC*, *supra* footnote 666.

<sup>697</sup> See *In the Matter of Energy Capital Partners*, *supra* footnote 30.

<sup>698</sup> See *In the Matter of Platinum Equity Advisors, LLC*, *supra* footnote 666.

<sup>699</sup> See *id.*



benefited the adviser rather than pro rata among the adviser's funds and co-investors invested in the portfolio company investment.<sup>700</sup>

A commenter specifically suggested that we refrain from defining “pro rata” to allow advisers flexibility because there are multiple methods that can be used to allocate pro rata.<sup>701</sup> We agree that there may be multiple methods to determine pro rata allocations, and we have therefore declined to define “pro rata.” We recognize that the framework we are adopting could result in some subjectivity regarding how advisers calculate pro rata and when an allocation is fair and equitable. Nonetheless, we believe that this framework offers additional protection to investors in situations where an adviser may have an incentive to favor one client (or a group of investors) over another client (or another group of investors). This framework requires an adviser to evaluate its conflicts of interest when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment and enhances protections and disclosures made to investors when an adviser allocates or charges fees and expenses in a non-pro rata manner.

## **2. Restricted Activities with Certain Investor Consent Exceptions**

### **a) Investigation Expenses**

We proposed to prohibit advisers from charging their private fund clients for fees and expenses associated with an investigation of the adviser or its related persons by any

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<sup>700</sup> See *In the Matter of WL Ross & Co. LLC*, *supra* footnote 666 (the adviser retained for itself the portion of transaction fees attributable to the co-investors' ownership of the portfolio company, without subjecting such fees to any management fee offsets).

<sup>701</sup> See IAA Comment Letter II; AIC Comment Letter I. *But see* Ropes & Gray Comment Letter (suggesting that we define the concept of “pro rata” to make the rule easier to apply in certain circumstances).

governmental or regulatory authority. We are adopting this provision<sup>702</sup> but, after considering comments, we are providing an exception from the proposed prohibition if an adviser seeks consent from all investors of a private fund, and obtains written consent from at least a majority in interest of the fund's investors that are not related persons of the adviser, for charging the private fund for such investigation fees or expenses.<sup>703</sup> However, the exception does not apply to fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Act or the rules promulgated thereunder.

The heightened protection of investor consent is particularly appropriate with respect to the investigation restriction because such investigations are focused on the adviser's own potential or actual wrongdoing. If an adviser is able to pass on expenses associated with an investigation related to its own misfeasance, without providing disclosure of the specific fees and expenses actually being passed through to funds relating to a particular investigation and securing consent from investors, such adviser has adverse incentives to engage in conduct likely to trigger an investigation and may not be adequately incentivized to limit the legal fees incurred on its own behalf.<sup>704</sup> An adviser faces a conflict of interest when charging investors for fees and expenses associated with an investigation of the adviser by any governmental or regulatory

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<sup>702</sup> In a change from the proposal, we are revising this requirement to capture not only amounts "charged" to the private fund but also fees and expenses "allocated to" the private fund. We believe that this clarification is necessary in light of the various ways that a private fund may be caused to bear fees and expenses.

<sup>703</sup> Final rule 211(h)(2)-1(a)(1). We are also reiterating that charging these expenses without authority in the governing documents is inconsistent with an adviser's fiduciary duty and may violate the antifraud provisions of the Act. For purposes of requesting consent under this rule, advisers generally should list each category of fee or expense as a separate line item, rather than group fund expenses into broad categories, and describe how each such fee or expense is related to the relevant investigation.

<sup>704</sup> See *infra* sections VI.C.2 and VI.D.3.

authority because these fees and expenses are related to the adviser's potential or actual wrongdoing.

We 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.

Some commenters supported the proposed prohibition, stating that advisers should not be charging investigation fees and expenses to the fund.<sup>705</sup> Other commenters stated that this prohibition is unnecessary, at least in part because investors are already able to agree on what fees may or may not be charged to funds.<sup>706</sup> Several commenters suggested that we should require disclosure of these expenses instead of prohibiting these practices.<sup>707</sup> In particular, as an alternative to the proposed prohibition, one commenter recommended that any such expenses should be fully disclosed to investors as separate line items<sup>708</sup> while another commenter recommended that we should require clear empirical disclosure of such expenses.<sup>709</sup> Others predicted that advisers would assess higher management fees if they could not allocate these fees and expenses to funds.<sup>710</sup> Some commenters suggested that we should clarify that certain costs and expenses resulting from settlements and judgments with governmental authorities are not indemnifiable.<sup>711</sup>

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<sup>705</sup> See, e.g., AFR Comment Letter I; United for Respect Comment Letter I; NYC Comptroller Comment Letter.

<sup>706</sup> See, e.g., Sullivan & Cromwell Comment Letter; NYC Bar Comment Letter II; ASA Comment Letter.

<sup>707</sup> See, e.g., AIMA/ACC Comment Letter; SBAI Comment Letter.

<sup>708</sup> See SBAI Comment Letter.

<sup>709</sup> See NYC Bar Comment Letter II.

<sup>710</sup> See, e.g., Dechert Comment Letter; Haynes & Boone Comment Letter; Chamber of Commerce Comment Letter.

<sup>711</sup> See, e.g., CalPERS Comment Letter; NYC Comptroller Comment Letter; ILPA Comment Letter I.

Charging investors separately for fees and expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority is a compensation scheme contrary to the public interest, unless this practice is consented to, in writing, by investors who are not related persons of the adviser. Such fees and expenses are related to the adviser's potential or actual wrongdoing and should be borne by the adviser unless investors consent in writing to paying them for each specific investigation. Accordingly, the allocation or charging of these types of expenses to private fund clients constitutes a compensation scheme within the meaning of section 211(h) of the Advisers Act because it is a method by which an investment adviser may take additional compensation in the form of reimbursement for expenses that the adviser should bear.<sup>712</sup> Moreover, such allocations create a conflict of interest because they provide an incentive for an adviser to place its own interests ahead of the private fund's interests and allocate expenses away from the adviser to the fund.<sup>713</sup> In such a case where an adviser incurs expenses as a result of an investigation into the adviser's conduct, then uses investor assets to pay the expenses associated thereto, investors have the potential to be doubly harmed if the adviser's alleged misconduct harms investors.<sup>714</sup> We also believe that allocation of these types of fees and expenses to private fund clients can be deceptive in current market practice. For example, investors may generally expect an adviser to bear fees and expenses

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<sup>712</sup> See *supra* section I for a discussion of the definition of "compensation scheme".

<sup>713</sup> See, e.g., *See, e.g., In the Matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC*, *supra* footnote 26 (alleging that the adviser improperly shifted expenses related to an examination and an investigation away from itself).

<sup>714</sup> One commenter stated that the proposed prohibition on advisers charging their private fund clients for these expenses is unnecessary because the Commission has the authority, as a condition of the settlement, to require advisers to bear the costs associated with a settlement or penalty. See Citadel Comment Letter. We view this authority as supporting the need for a broader rule in this area rather than relying on invocations of this authority in each separate instance. In addition, relying on imposing this condition as a condition of settlement, by which point an adviser who has committed fraud may have dissipated its money and be unable to reimburse investors for the investigation expenses already charged, provides inadequate and lesser protection to investors compared to the rule's consent requirement.

directly related to its own wrongdoing. Regarding fees and expenses associated with investigation of the adviser or its related persons, we do not believe it is appropriate for an adviser to enrich itself by charging for investigation fees and expenses related to its own actual or potential wrongdoing, unless investors consent to such fees and expenses. Thus, we believe that, unless this practice is consented to, in writing, by investors, it creates a compensation scheme that is contrary to the public interest and the protection of investors.

After reviewing responses from commenters, however, we acknowledge that 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, as some commenters suggested,<sup>715</sup> 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. We also recognize that whether such fees and expenses can be charged to the private fund can be highly negotiated by investors in certain instances.<sup>716</sup> As a result, we believe it is necessary to prohibit these practices unless advisers get requisite written consent from investors.

The final rule, however, does not contain a consent-based exception for an adviser to charge a fund for fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Act or the rules promulgated thereunder. Such charges will be outright prohibited. If an adviser were to charge a client for

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<sup>715</sup> See, e.g., Dechert Comment Letter; Haynes & Boone Comment Letter; Chamber of Commerce Comment Letter.

<sup>716</sup> However, even in such circumstances where investigation fee and expense allocation provisions are highly negotiated, we believe such negotiation is only effective if investors explicitly consent to any such allocations in each specific instance.

such fees and expenses, we would view that adviser as requiring its client to acquiesce to the adviser's violation of the Act. Advisers must comply with all applicable provisions of the Act, and the SEC would view a waiver of any provision of the Act as invalid under section 215(a) of the Act. Section 215(a) of the Act provides that any condition, stipulation, or provision binding any person to waive compliance with any provision of the Act shall be void.<sup>717</sup> An adviser that charges its private fund client for fees and expenses related to the adviser's violation of the Act, or the rules promulgated thereunder, would operate as a waiver of its liability for such violation. While other types of investigations may involve a great variety of potential or actual wrongdoing that may differ in nature and severity, compliance with the Act is core to the existence and activities of investment advisers. Accordingly, an adviser charging its private fund client for 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 Act, or the rules promulgated thereunder, is impermissible.<sup>718</sup>

To illustrate, an adviser may charge a private fund client for fees and expenses associated with an investigation by the SEC of the adviser or its related persons for a potential violation of Section 206 of the Act or the rules thereunder, provided those fees and expenses are consented to by investors pursuant to this rule. However, if the investigation results in a court or governmental authority imposing a sanction on the adviser for a violation of the Act or the rules

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<sup>717</sup> See section 215(a) of the Advisers Act. See also section 215(b) of the Advisers Act (stating that any contract made in violation of the Act or rules thereunder is void).

<sup>718</sup> For example, if the Commission sanctioned an adviser pursuant to a settled order finding that the adviser violated the Act or the rules promulgated thereunder, including an order to which the adviser consented without admitting or denying the Commission's findings, the adviser would not be permitted to seek investor consent to charge any fees and expenses related to the Commission's investigation to the fund, including any penalties or disgorgement.

promulgated thereunder, then the adviser must refund the fund for the fees and expenses associated with the investigation, such as lawyer's fees.

Some commenters also expressed concerns about how the proposed prohibition related to investigation expenses would adversely impact funds with "pass-through" expense models.<sup>719</sup> First, investigations of advisers by governmental authorities are uncommon, and thus we do not expect expenses related to investigations to pose a threat to the majority of advisers using pass-through expense models. Second, since we are providing a consent-based exception from this prohibition, advisers with pass-through expense models are still able to charge investigation expenses to the funds they advise, provided they obtain investor consent pursuant to this rule (subject to compliance with other applicable disclosure and consent requirements). Thus, the final rule generally does not prohibit advisers from continuing to utilize such models. Such advisers, like any other private fund adviser, would nonetheless be prohibited from allocating to such funds fees or expenses related an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Act, or the rules promulgated thereunder.<sup>720</sup>

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<sup>719</sup> See, e.g., BVCA Comment Letter; Sullivan & Cromwell Comment Letter; SBAI Comment Letter.

<sup>720</sup> The obligation of an adviser to a pass-through fund to pay fees or expenses associated with a sanction under the Act is attenuated to the extent such adviser has other assets (e.g., balance sheet capital), sources of revenue (e.g., performance-based compensation), or access to capital (e.g., loans) to pay any such fees or expenses. As the Commission may already require advisers to pass-through funds to pay penalties associated with a sanction under the Act, we anticipate that this rule will not cause a significant disruption from current practice for advisers to pass-through funds.

## **b) Borrowing**

We proposed to prohibit an adviser directly or indirectly from borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client (collectively, a “borrowing”).<sup>721</sup>

Some commenters opposed the prohibition,<sup>722</sup> while others supported it.<sup>723</sup> One commenter encouraged the Commission to expand the scope of the proposed prohibition by preventing an adviser from borrowing from co-investment vehicles or other accounts.<sup>724</sup> Another commenter that opposed the proposed prohibition stated that the prohibition was unnecessary because advisers and their related persons rarely borrow from fund clients.<sup>725</sup> These commenters asserted that the proposed prohibition could inadvertently prohibit activity that could benefit investors, such as tax advances,<sup>726</sup> borrowing arrangements outside of the fund structure,<sup>727</sup> and the activity of service providers that are affiliates of the adviser, especially with large financial institutions that play many roles in a private fund complex.<sup>728</sup> Commenters also stated that the rule could prohibit certain types of transactions that are permitted (*e.g.*, an adviser purchasing securities from a client), with appropriate disclosure and consent, under section

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<sup>721</sup> Proposed rule 211(h)(2)-1(a)(7).

<sup>722</sup> See SIFMA-AMG Comment Letter I; NYC Bar Comment Letter II; IAA Comment Letter II.

<sup>723</sup> See OPERS Comment Letter; Convergence Comment Letter; AFL-CIO Comment Letter; ILPA Comment Letter I; RFG Comment Letter II; American Association for Justice Comment Letter.

<sup>724</sup> See Convergence Comment Letter.

<sup>725</sup> See NYC Bar Comment Letter II.

<sup>726</sup> Tax advances occur when the private fund pays or distributes amounts to the general partner to allow the general partner to cover tax obligations.

<sup>727</sup> See SBAI Comment Letter; CFA Comment Letter I; AIC Comment Letter I.

<sup>728</sup> See IAA Comment Letter II.



206(3) of the Advisers Act.<sup>729</sup> One commenter stated that we should instead require disclosure of adviser borrowings on Form PF and Form ADV,<sup>730</sup> while other commenters stated that we should provide exemptions for borrowings disclosed to investors or LPACs to ensure that these arrangements are entered into on arm's length terms.<sup>731</sup>

Under section 211(h)(2) of the Advisers Act, the Commission has the authority to promulgate rules to prohibit or restrict certain conflicts of interest that the Commission deems contrary to the public interest and the protection of investors. We believe it is important to restrict the practice of borrowing from a private fund client because it presents a conflict of interest that is contrary to the public interest and the protection of investors. When an adviser borrows from a private fund, that adviser has a conflict of interest because it is on both sides of the transaction (*i.e.*, the adviser benefits from the loan and manages the client lender). As discussed above, a private fund rarely has employees of its own. The fund typically relies on the investment adviser (and, in certain cases, affiliated entities) to provide management, investment, and other services, and such persons usually have general authority to take actions on behalf of the private fund without further consent or approval of any other person. This structure causes a conflict of interest between the private fund (and, by extension, its investors) and the investment adviser because the interests of the fund are not necessarily aligned with the interests of the adviser. For example, when determining the interest rate for the borrowing, an investment adviser's interest in maximizing its own profit by negotiating (or setting) a low rate may conflict

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<sup>729</sup> See, e.g., SIFMA-AMG Comment Letter I (stating that borrowing securities can be structured as a purchase subject to section 206(3) of the Advisers Act); NYC Bar Comment Letter II. To the extent that a borrowing under the final rule involves a purchase under section 206(3) of the Advisers Act, the requirements of that section will continue to apply to the adviser.

<sup>730</sup> See Convergence Comment Letter.

<sup>731</sup> See, e.g., IAA Comment Letter II; AIC Comment Letter I.

with the private fund's (and, by extension, its investors') interest in seeking to maximize the profits of the fund. As another example, if the adviser becomes insolvent or suffers financial distress, the interests of the fund in seeking to protect its interests (whether through enforcing a default against, or renegotiating the terms of the loan with, the adviser) may conflict with the interests of the adviser in seeking to discharge the liability or otherwise renegotiate more favorable terms for itself.

Additionally, this practice may prevent the fund client from using those assets to further the fund's investment strategy. Even where disclosed to investors (or to an advisory board of the private fund, such as an LPAC), this practice presents a conflict of interest that can be harmful to investors because, as a result of the unique structure of private funds, only certain investors with specific information or governance rights (such as representation on the LPAC) may be in a position to discuss, diligence, negotiate, consent to, or monitor the borrowing with the adviser, rather than all of the private fund's investors, depending on the facts and circumstances.

Further, section 206(4) of the Advisers Act permits the Commission to prescribe a means to prevent acts, practices, and courses of business that are fraudulent, deceptive, or manipulative. Restricting the ability of an adviser to borrow from a private fund client would help prevent fraud, deception, and manipulation that can occur when an adviser engages in this practice. The Commission has previously settled enforcement actions against advisers that directly or indirectly borrowed from private fund clients without providing appropriate disclosure or obtaining approval.<sup>732</sup> For example, the Commission brought charges against a private fund

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<sup>732</sup> See *SEC v. Philip A. Falcone, et al.*, Civil Action 12-CV-5027 (S.D.N.Y) (Aug. 16, 2013) (consent of defendants) (admitting that a hedge fund adviser borrowed from a hedge fund client, at an interest rate lower than the fund's borrowing rate, in order to repay the adviser's personal taxes, and that the adviser failed to disclose the loan to investors for five months); *In the Matter of Wave Equity Partners LLC*, Investment Advisers Act Release No. 6146 (Sept. 23, 2022) (settled action) (alleging that the adviser (i)

adviser and its owner for, among other things, improperly borrowing money from a private fund.<sup>733</sup> Specifically, the Commission order alleged that the owner breached his fiduciary duty when he borrowed from the fund to settle a personal trade. In another example, the Commission found that an investment adviser, through its owner, improperly borrowed money from private funds to pay the adviser's expenses.<sup>734</sup> In both instances, the advisers did not timely disclose or obtain approval for the borrowings. The advisers also defrauded the private funds and their investors by illegally using the private funds' assets to serve their personal interests. Despite the Commission's enforcement efforts, adviser borrowing practices continue to pose harmful risks to private funds (and, by extension, their investors) in light of the conflicts of interests that arise between a fund and its adviser when the adviser has a direct or indirect interest on both sides of a borrowing arrangement.

After considering comments and in a change from the proposal, the final rule prohibits advisers from engaging in borrowings from a private fund client unless the adviser distributes a written notice and description of the material terms of the borrowing to the investors of the private fund, seeks their consent for the borrowing, and obtains written consent from at least a majority in interest of the fund's investors that are not related persons of the adviser (as

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borrowed money from a private equity fund that it managed in order to pay placement agent fees to a third-party vendor; and (ii) without adequate disclosure, failed promptly to repay the fund through an offset of quarterly management fees as required by fund documents); *In the Matter of SparkLabs Global Ventures Management, LLC, et al.*, Investment Advisers Act Release No. 6121 (Sept. 12, 2022) (settled action) (alleging that exempt reporting advisers and their owner (i) directed certain funds they managed to make more than 50 unauthorized loans totaling over \$4.4 million, at below-market interest rates, to other funds under their management and certain affiliates of the adviser and/or its related persons; (ii) failed to enforce the terms of the loans when they were due; and (iii) failed to disclose to their clients or investors the conflicts of interest associated with the loans and to seek approval for them).

<sup>733</sup> See *In the Matter of Monsoon Capital, LLC*, Investment Advisers Act Release No. 5490 (Apr. 30, 2020) (settled action).

<sup>734</sup> See *In the Matter of Resilience Management, LLC, et al.*, Investment Advisers Act Release No. 4721 (June 29, 2017) (settled action).

described above).<sup>735</sup> The final rule does not enumerate specific terms of the borrowing that must be disclosed in connection with an adviser's consent request; rather, it 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. We believe that this approach will help prevent activity that is potentially harmful unless accompanied by specific and timely disclosure that can be meaningfully evaluated and acted upon by investors. By not enumerating specific terms that must be disclosed and instead incorporating a materiality standard, the final rule will also afford investors and advisers the flexibility to negotiate for disclosures and terms that are tailored to their unique needs and relationships.<sup>736</sup>

The heightened protection of investor consent is particularly appropriate with respect to the borrowing restriction. Borrowing from a private fund creates a conflict of interest where the adviser is incentivized to favor its own interest over the interest of the fund. Additionally, there are other potential conflicts that arise in the event that the adviser is unable to repay the borrowing, or it has to choose whether to repay the borrowing among other uses of the capital when funds are limited. This 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, based on our experience, present the greatest opportunities for an adviser to abuse its control over a client's assets; namely, when an adviser borrows its client's assets, directly or

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<sup>735</sup> Final rule 211(h)(2)-1(a)(5). *See supra* section II.E. (Restricted Activities) for discussions of the "distribution" requirement and of the type and manner of investor consent required under the final rule.

<sup>736</sup> Advisers may also consider providing additional information, including, to the extent relevant, updated post-borrowing disclosure to reflect increases, decreases, or other changes in the borrowing, to help investors understand the nature of the conflict of interest and its potential influence on the adviser.

indirectly, for its own use. However, we recognize that, in certain instances, such as in connection with enabling a smaller adviser to satisfy a sponsor commitment to the fund, investors may under certain terms be willing to accept a borrowing from the fund by the adviser.<sup>737</sup> Rather than prescribe these terms, the final rule will require that advisers disclose and obtain advance written consent for them from investors, as discussed above. In this way, the rule will enable investors to have an opportunity to evaluate whether a proposed borrowing would be favorable for the fund (as opposed to only for the adviser) and, relatedly, to negotiate for changes to the terms of the borrowing as appropriate.

Because we are providing a consent-based exception from this prohibition, the revised approach is responsive to commenters who stated that the rule should be based on more express disclosure to, and consent from, investors rather than prohibition-based. We were not persuaded, however, by comments suggesting that the *manner* of disclosure about adviser borrowings should be through Form ADV or Form PF. We believe that disclosure directly to investors, in the format contemplated by the final rule and in connection with an adviser's consent request, will better ensure that existing investors have timely access to information that will assist those investors in determining the conflicts related to such borrowings and how they impact the adviser's relationship with the private fund, whether the borrowing would be in the fund's or the adviser's interest, and whether to ultimately approve or disapprove of the borrowing. Additionally, the related books and records requirement in final rule 204-2(a)(24) will require advisers to maintain this information in a manner that permits easy location, access, and retrieval of any particular record.

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<sup>737</sup> See, e.g., ILPA Comment Letter I.

Finally, in response to commenters, we are clarifying that we did not intend for the proposed rule to prohibit certain practices that have the potential to benefit investors, and we would not interpret ordinary course tax advances and management fee offsets as borrowings that are subject to this final rule, as discussed below.

A tax advance occurs when a fund provides an adviser or its affiliate an advance of money against the adviser's actual or expected future share of the fund's assets (*e.g.*, the adviser's accrued performance fees or carried interest) to allow the adviser or its affiliate to meet certain of its tax obligations (or its investment professionals' tax obligations) as they are due. Such advances are used to enable an adviser, its affiliates, and its investment professionals to pay taxes derived from their interest in a fund (*e.g.*, taxes associated with performance fees or carried interest that have been allocated to the affiliated general partner), because such tax liabilities frequently arise and are due before these parties are actually entitled to a cash distribution from the fund. This practice can benefit investors because it allows advisers to pay their tax liabilities while continuing to manage the fund and, accordingly, to avoid the potential misalignment of interests that can occur if advisers were instead to seek higher amounts of compensation from a fund (or from fund portfolio investments) to create a reserve amount covering their potential tax liabilities or to begin timing portfolio investment transactions in consideration of the resulting tax impacts on the adviser and its affiliates and their personnel (as opposed to managing the fund with a focus solely on the best interests of the fund).<sup>738</sup> Some commenters suggested that such arrangements are widely disclosed to and understood by investors.<sup>739</sup> We do not interpret the

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<sup>738</sup> Commenters state that prohibiting this practice would harm smaller advisers and raise barriers to entry because such advisers would not be able to fund such tax payments. *See* SBAI Comment Letter; AIMA/ACC Comment Letter; AIC Comment Letter III.

<sup>739</sup> *See, e.g.*, MFA Comment Letter II; SBAI Comment Letter; AIMA/ACC Comment Letter; AIC Comment Letter I; AIC Comment Letter II.

final rule to apply to tax advances as a type of restricted borrowing because they are tax payments that are attributable to and made against the unrealized income (or other amounts) allocated to in respect of the private fund. As such, they are not structured to include the repayment of advanced amounts to the fund, but rather only the reduction of the future income to be received by the adviser. However, to the extent that a tax advance is structured to contemplate amounts that will be repaid to the fund, as opposed to amounts that only reduce an adviser's future income, it would generally be a restricted borrowing under the final rule, subject to the rule's consent requirement.

Similarly, management fee offsets are not borrowings subject to the final rule because they do not involve the adviser or its affiliates taking fund assets and promising to repay such assets at a later date. Management fee offsets typically occur when an adviser reduces the management fee owed by the fund by other amounts that the fund has already paid to, or on behalf of, the adviser, its affiliates, or certain other persons. For example, fund governing documents may require an adviser to reduce the management fee by any amounts the adviser's affiliates receive for providing services to a portfolio company that the fund invests in. Also, some private fund governing documents limit organizational expenses and provide that any amount of organizational expenses paid by the fund above the expense cap may be offset against the adviser's management fee. Management fee offsets benefit investors because they reduce the fees and expenses the fund pays to the adviser and its affiliates, typically on a dollar-for-dollar basis with the amount initially paid, directly or indirectly, by the fund. We therefore consider a management fee offset to be a calculation methodology that reduces the amount a fund pays the adviser and its affiliates in the future.

We also remind advisers of their fiduciary obligations when engaging in transactions with private fund clients and of their antifraud obligations when engaging with private fund investors. To satisfy its fiduciary duty, an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser to provide advice that is not disinterested.<sup>740</sup> Full and fair disclosure should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent.<sup>741</sup> 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.<sup>742</sup> When making disclosures to private fund investors, advisers should also be mindful of their antifraud responsibilities per rule 206(4)-8 under the Advisers Act.

## **F. Certain Adviser Misconduct**

### **1. Fees for Unperformed Services**

We are not adopting the proposed prohibition on charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment.<sup>743</sup> As discussed below, we believe that it is unnecessary for the final rule to prohibit an adviser from charging fees without providing a corresponding service to its private fund client because such activity already is inconsistent with the adviser's fiduciary duty.

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<sup>740</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at 23.

<sup>741</sup> See *id.*

<sup>742</sup> See *id.*, at 25-26.

<sup>743</sup> Proposing Release, *supra* footnote at 3, at 136.



Some commenters supported this prohibition.<sup>744</sup> Commenters generally stated that charging fees for unperformed services to the fund is against the public interest and inconsistent with the Advisers Act by placing the interests of the advisers ahead of those of investors.<sup>745</sup> A commenter suggested that because of the substantial conflicts of interest faced by advisers charging fees for unperformed services no amount of disclosure should be enough to enable an investor to provide informed consent to these practices.<sup>746</sup> Another commenter indicated that an adviser should refund prepaid amounts attributable to unperformed services where an adviser is paid in advance for services that it reasonably expects to perform but ultimately does not provide.<sup>747</sup> A commenter expressed concern that advisers have not historically provided enough transparency into certain payments, such as monitoring fees.<sup>748</sup>

Other commenters opposed this prohibition for several reasons. First, commenters stated that this prohibition may be unnecessary because it is generally market practice for fund documents to prohibit advisers from charging fees for unperformed services or, less commonly, to disclose such practices.<sup>749</sup> Second, a commenter indicated that certain advisers may structure fee arrangements based on the value expected to be created, rather than based on a time-worked

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<sup>744</sup> Comment Letter of Eileen Appelbaum and Jeffrey Hooke (Mar. 17, 2022); Comment Letter of Senators Sherrod Brown and Jack Reed (Aug. 4, 2022) (“Senators Brown and Reed Comment Letter”); Trine Comment Letter; AFREF Comment Letter I; OPERS Comment Letter; Morningstar Comment Letter; ILPA Comment Letter I; For The Long Term Comment Letter; Healthy Markets Comment Letter I; Predistribution Initiative Comment Letter II; NYSIF Comment Letter.

<sup>745</sup> Morningstar Comment Letter; Healthy Markets Comment Letter I.

<sup>746</sup> Senators Brown and Reed Comment Letter.

<sup>747</sup> ILPA Comment Letter I.

<sup>748</sup> *See generally* AFREF Comment Letter I.

<sup>749</sup> *See* SIFMA-AMG Comment Letter I; Invest Europe Comment Letter; *see generally* Dechert Comment Letter.

model.<sup>750</sup> Third, a commenter expressed concerns that the “reasonably expect” standard is inappropriate because of the risk that advisers would be second-guessed afterwards.<sup>751</sup>

Fees for unperformed services may incentivize an adviser to cause a private fund to exit a portfolio investment earlier than anticipated. We stated in the proposal that such fees may cause an adviser to seek portfolio investments for its own benefit rather than for the private fund’s benefit.<sup>752</sup> In addition, we noted that such fees have the potential to distort the economic relationship between the private fund and the adviser because the adviser receives the benefit of such fees, at the expense of the fund, without incurring any costs associated with having to provide any services.

We believe that charging a client fees for unperformed services (including indirectly by charging fees to a portfolio investment held by the fund) where the adviser does not, or does not reasonably expect to, provide such services is inconsistent with an adviser’s fiduciary duty.<sup>753</sup> Typically by its nature charging a client fees for unperformed services, directly or indirectly, involves a misrepresentation or an omission of a material fact, whether in the private fund’s offering memorandum or otherwise, regarding the amount being charged to the client, directly or indirectly, by the adviser or the adviser’s related person, the nature of the services being provided by the adviser or the adviser’s related person, or both. An adviser’s fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. This fiduciary duty

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<sup>750</sup> AIC Comment Letter I.

<sup>751</sup> Dechert Comment Letter.

<sup>752</sup> See Proposing Release, *supra* footnote 3, at 137.

<sup>753</sup> We proposed to adopt this rule under sections 206 and 211 of the Advisers Act. Proposing Release, *supra* footnote 3, at 134. See also 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at 1 and n.2-3 (discussing an adviser’s fiduciary duty under Federal law).

requires an adviser “to adopt the principal’s goals, objectives, or ends.”<sup>754</sup> This means the adviser must, at all times, serve the best interest of its client and not subordinate its client’s interest to its own.<sup>755</sup> In other words, the adviser cannot place its own interests ahead of its client’s interests. Because charging fees without providing or reasonably expecting to provide a corresponding service to its private fund client, in our view, would cause the adviser to place its own interests ahead of its client’s interests, as more fully described in the paragraph below, we have determined that it is unnecessary to prohibit activity that is already indirectly inconsistent with the adviser’s fiduciary duty.<sup>756</sup> Thus, we are not adopting the rule as originally proposed. Commenters’ statements that it is generally market practice for fund documents to prohibit advisers from charging fees for unperformed services may suggest that market participants are acting consistent with the adviser’s fiduciary duty and that private fund advisers do not engage in these compensation practices.

Previously, we have charged advisers for violating section 206(2) of the Advisers Act when improperly charging monitoring, servicing, consulting, or other fees, which may accelerate upon the occurrence of certain events, to a portfolio investment.<sup>757</sup> These fees reduce the value of the fund’s portfolio investment, which, in turn, reduces the amount available for distribution to the fund’s investors. Because the adviser or its related person receives these fees, it faces a

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<sup>754</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at 7-8.

<sup>755</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at n.58.

<sup>756</sup> Section 206(1) and section 206(2) of the Advisers Act. Depending on the facts and circumstances, we believe that this conduct may also violate other Federal securities laws, rules, and regulations, such as rule 206(4)-8, which prohibits advisers to pooled investment vehicles from, among other things, defrauding investors or prospective investors.

<sup>757</sup> See, e.g., *In the Matter of THL Managers V, LLC and THL Managers VI, LLC*, Investment Advisers Act Release No. 4952 (June 29, 2018) (settled action); *In the Matter of TPG Capital Advisors, LLC*, Investment Advisers Act Release No. 4830 (Dec. 21, 2017) (settled action); *In the Matter of Apollo Management V, L.P., et al.*, Investment Advisers Act Release No. 3392 (Aug. 23, 2016) (settled action); *In the Matter of Blackstone*, *supra* footnote 26.

significant conflict of interest and cannot effectively consent on behalf of the fund. The conflict of interest from these fee arrangements can lead an adviser in other ways to act to serve its interest over its client's interest, in breach of its fiduciary duty. For example, fees for unperformed services may incentivize an adviser to cause a private fund to exit a portfolio investment earlier than anticipated or cause an adviser to seek portfolio investments for its own benefit rather than for the private fund's benefit. If the adviser reasonably expects to provide services to a portfolio investment, the adviser may attempt to provide full and fair disclosure to all investors or a group representing all investors, such as a fund board or an LPAC.<sup>758</sup> But, in some instances, disclosure may be insufficient. We have long brought enforcement actions based on the view that an adviser, as a fiduciary, may not keep prepaid advisory fees for services that it does not, or does not reasonably expect to, provide to a client.<sup>759</sup> And an adviser cannot do indirectly what it is not permitted to do directly.<sup>760</sup> Thus, where the adviser does not, or does not reasonably expect to, provide services to the portfolio investment, the adviser would be violating its fiduciary duty by using its position to extract payments indirectly from a fund, through a portfolio investment.

Under our interpretation, an adviser could receive payment for services actually provided. An adviser could also receive payments in advance for services that it reasonably expects to provide to the portfolio investment in the future, whether such arrangements are based on a time-worked model (*i.e.*, where fees are determined based on a fixed dollar amount and the amount of

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<sup>758</sup> Advisers that are subject to the quarterly statement rule discussed above will also need to disclose these amounts in the quarterly statement provided to investors, to the extent such compensation meets the definition of portfolio-investment compensation.

<sup>759</sup> See *Jason Baker Tuttle, Sr.*, Initial Decision Release No. 13 (Jan. 8, 1990); *Monitored Assets Corp.*, Investment Advisers Act Release No. 1195 (Aug. 28, 1989) (settled order); *In the Matter of Beverly Hills Wealth Mgmt., LLC*, Investment Advisers Act Release No. 4975 (July 20, 2018) (settled order).

<sup>760</sup> Section 208(d) of the Advisers Act.

time worked) or a value-add model (*i.e.*, where the fees are determined based on the value contributed by the adviser’s services).<sup>761</sup> For example, if an adviser expects to provide monitoring services to a portfolio investment, the adviser is not prohibited from charging for those services. Rather, an adviser is not permitted to charge for services that it does not reasonably expect to provide. Further, to the extent that the adviser ultimately does not provide the services, the adviser would need to refund any prepaid amounts attributable to unperformed services.

## **2. Limiting or Eliminating Liability**

We proposed to prohibit an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund (“waiver or indemnification prohibition”).<sup>762</sup> As discussed further below, we are not adopting this prohibition, in part, because we believe that it is not necessary to achieve our goal to address this problematic practice. Rather, we discuss below our views on how an adviser’s fiduciary duty applies to its private fund clients and how the antifraud provisions apply to the adviser’s dealings with clients and fund investors.

Some commenters supported this prohibition<sup>763</sup> stating that the prohibition is necessary to protect private fund investors, address the increasing erosion of private fund advisers’ fiduciary

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<sup>761</sup> See AIC Comment Letter I (stating that “[i]f monitoring fees are charged based on the deal size, periodic payments instead of a lump sum payment can provide the portfolio company with liquidity management by spreading the costs over time, even though the services and resulting value creation may not correspond to the same time period of payments.”).

<sup>762</sup> Proposed rule 211(h)(2)-1(a)(5).

<sup>763</sup> See, e.g., Comment Letter of Phil Thompson (Mar. 8, 2022) (“Thompson Comment Letter”); OPERS Comment Letter; CalPERS Comment Letter; Morningstar Comment Letter.

duties,<sup>764</sup> and save investors time and legal fees when negotiating fund documents.<sup>765</sup> One commenter that represents several limited partners and historically advocated for increased protections regarding fiduciary terms<sup>766</sup> supported allowing indemnification for an adviser’s simple negligence but maintaining the proposed prohibition on indemnification for simple negligence in scenarios where there is a material breach of the limited partnership agreement and side letters.<sup>767</sup> Some commenters suggested narrowing this provision to align with the Commission’s statement in the 2019 IA Fiduciary Duty Interpretation, instead of adopting a broader prohibition that, according to commenters, would implicate State and local law.<sup>768</sup>

In contrast, most commenters opposed it.<sup>769</sup> Some commenters stated that the proposed prohibition would increase costs for investors<sup>770</sup> (including through insurance premiums, higher management fees, and revising existing agreements),<sup>771</sup> increase the threat of private litigation,<sup>772</sup> and cause advisers to take less risk, which could result in lower investor returns and fewer available strategies.<sup>773</sup> Many commenters stated that the proposed prohibition would result in more onerous liability standards for sophisticated investors than for retail investors and

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<sup>764</sup> See, e.g., NYC Comptroller Comment Letter; OPERS Comment Letter; Thompson Comment Letter; Better Markets Comment Letter.

<sup>765</sup> See NACUBO Comment Letter.

<sup>766</sup> See ILPA Letter to Chairman Gensler (Apr. 21, 2021).

<sup>767</sup> See ILPA Comment Letter I.

<sup>768</sup> See Invest Europe Comment Letter; MFA Comment Letter I.

<sup>769</sup> See, e.g., SBAI Comment Letter; Thin Line Capital Comment Letter; ATR Comment Letter; ILPA Comment Letter I; Chamber of Commerce Comment Letter; Comment Letter of Real Estate Roundtable Comment Letter (Apr. 25, 2022); CVCA Comment Letter; AIMA/ACC Comment Letter.

<sup>770</sup> See, e.g., Chamber of Commerce Comment Letter; MFA Comment Letter I.

<sup>771</sup> See, e.g., Schulte Comment Letter; Comment Letter of Real Estate Board of New York (Apr. 21, 2022) (“REBNY Comment Letter”); CVCA Comment Letter.

<sup>772</sup> See, e.g., Invest Europe Comment Letter; Schulte Comment Letter; MFA Comment Letter I.

<sup>773</sup> See, e.g., TIAA Comment Letter; SIFMA-AMG Comment Letter I; ILPA Comment Letter I; AIC Comment Letter I; NYC Bar Comment Letter II.

that such a difference would result in better protection for institutional investors than for investors in retail products.<sup>774</sup>

After considering comments, we are not adopting this prohibition, in part, because we believe that it is not needed to address this problematic practice. Rather, we are reaffirming and clarifying our views on how an adviser's fiduciary duty applies to its private fund clients and how the antifraud provisions apply to the adviser's dealings with clients and fund investors. We remind advisers of their obligation to act consistently with their Federal fiduciary duty and their legal obligations under the Advisers Act, including the antifraud provisions.<sup>775</sup> A waiver of an adviser's compliance with its Federal antifraud liability for breach of its fiduciary duty to the private fund or otherwise, or of any other provision of the Advisers Act, or rules thereunder, is invalid under the Act.<sup>776</sup>

An adviser's Federal fiduciary duty is to its clients and the obligations that flow from the adviser's fiduciary duty depend upon what functions the adviser, as agent, has agreed to assume for the client, its principal.<sup>777</sup> In addition, full and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand

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<sup>774</sup> See, e.g., Invest Europe Comment Letter; Schulte Comment Letter; SBAI Comment Letter; SIFMA-AMG Comment Letter I; AIC Comment Letter I; MFA Comment Letter I; AIMA/ACC Comment Letter.

<sup>775</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5; section 206 of the Advisers Act.

<sup>776</sup> See section 215(a) of the Advisers Act; 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at n.29 (stating that an adviser's Federal fiduciary obligations are enforceable through section 206 of the Advisers Act and that the SEC would view a waiver of enforcement of section 206 as implicating section 215(a) of the Advisers Act. Section 215(a) of the Advisers Act provides that any condition, stipulation or provision binding any person to waive compliance with any provision of the title shall be void.). See section 215(b) of the Advisers Act (stating that any contract made in violation of the Act or rules thereunder is void).

<sup>777</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 558, at section I (reaffirming and clarifying the fiduciary duty that an adviser owes to its clients under section 206 of the Advisers Act).

complex conflicts and their ramifications.<sup>778</sup> Regardless of the nature of the client, 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. Accordingly, while the fiduciary duty itself applies to all clients of an adviser, the application of the fiduciary duty of an adviser to a retail client can be different from the specific application of the fiduciary duty of an adviser to a registered investment company or private fund.<sup>779</sup> Whether contractual clauses that purport to limit an adviser's liability (also known as "hedge clauses" or "waiver clauses") in an agreement with an institutional client (*e.g.*, private fund) would violate the Advisers Act's antifraud provisions will be determined based on the particular facts and circumstances.<sup>780</sup> To the extent that a hedge clause creates a conflict of interest between an adviser and its client, the adviser must address the conflict as required by its duty of loyalty.

After considering comments on the waiver or indemnification prohibition, we provide the following examples, partly based on staff observations, of how this interpretation applies to certain facts and circumstances. We have taken the position that an adviser violates the antifraud provisions of the Advisers Act, for example, when (i) there is a contract provision waiving any and all of the adviser's fiduciary duties or (ii) there is a contract provision explicitly or generically waiving the adviser's Federal fiduciary duty, and in each case there is no language clarifying that the adviser is not waiving its Federal fiduciary duty or that the client retains

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<sup>778</sup> See *id.* and accompanying text.

<sup>779</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at n.87. See also *In the Matter of Comprehensive Capital Management, Inc.*, Investment Advisers Act Release No. 5943 (Jan. 11, 2022) (settled action) (alleging adviser included in its investment advisory agreement liability disclaimer language (*i.e.*, a hedge clause), which could lead a client to believe incorrectly that the client had waived a non-waivable cause of action against the adviser provided by State or Federal law. Most, if not all, of the adviser's clients were retail investors.).

<sup>780</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at n.31 (discussing the now-withdrawn Heitman no-action letter that analyzed an indemnification provision in an institutional client's investment management agreement).



certain non-waivable rights (also known as a “savings clause”).<sup>781</sup> A breach of the Federal fiduciary duty may involve conduct that is intentional, reckless, or negligent.<sup>782</sup> Finally, we believe that an adviser may not seek reimbursement, indemnification, or exculpation for breaching its Federal fiduciary duty because such reimbursement, indemnification, or exculpation would operate effectively as a waiver, which would be invalid under the Act.<sup>783</sup>

We continue to not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable State law.<sup>784</sup> However, to the extent that a waiver clause is unclear as to whether it applies to the Federal fiduciary duty, State fiduciary duties, or both, we will interpret the clause as waiving the Federal fiduciary duty.

## **G. Preferential Treatment**

We proposed to prohibit all private fund advisers, regardless of whether they are registered with the Commission, from: (i) granting an investor in a private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser

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<sup>781</sup> *In the Matter of Comprehensive Capital Management.*, Investment Advisers Act Release No. 5943 (Jan. 11, 2022) (settled action). Also, we note that our staff has expressed the view that it would violate the antifraud provisions of the Advisers Act for an adviser to enter into a limited partnership agreement stating that the adviser to the private fund or its related person, which is the general partner of the fund, to the maximum extent permitted by applicable law, will not be subject to any duties or standards (including fiduciary or similar duties or standards) existing under the Advisers Act or that the adviser can receive indemnification or exculpation for breaching its Federal fiduciary duty. *See, e.g.*, EXAMS Risk Alert: Observations from Examinations of Private Fund Advisers (Jan. 27, 2022), at 5 (discussing hedge clauses.), *available at* <https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf>. *See also* Comment Letter of the Institutional Limited Partners Association on the Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation (Aug. 6, 2018) at 6, *available at* <https://ilpa.org/wp-content/uploads/2018/08/ILPA-Comment-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-August-6-2018.pdf>.

<sup>782</sup> *See, e.g.*, 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5, at n.20 (explaining that claims arising under Section 206(1) of the Advisers Act require a showing of scienter but claims under Section 206(2) of the Advisers Act are not scienter based and can be adequately pled with only a showing of negligence).

<sup>783</sup> *See supra* section II.E.2.a) (Investigation Expenses) (stating that charging fees and expenses related to a breach of an adviser’s Federal fiduciary duty to a private fund would effectively operate as a waiver of such duty, which would be invalid under the Act).

<sup>784</sup> *See* 2019 IA Fiduciary Duty Interpretation, *supra* footnote 558.

reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets and (ii) providing information regarding portfolio holdings or exposures of a private fund or of a substantially similar pool of assets to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.<sup>785</sup> We also proposed to prohibit these advisers from providing any other preferential treatment to any investor in the private fund unless the adviser delivers certain written disclosures to prospective and current investors regarding all preferential treatment the adviser or its related persons provide to other investors in the same fund.<sup>786</sup> The timing of the proposed rule's delivery requirements differed depending on whether the recipient is a prospective or existing investor in the private fund. For a prospective investor, the proposed rule required the adviser to deliver the notice prior to the investor's investment. For an existing investor, the notice was required to be delivered annually, to the extent the adviser provided preferential treatment to other investors since the last notice.

Some commenters supported the proposed rule.<sup>787</sup> Some of these commenters stated that the rule would benefit investors by increasing transparency for all investors about the terms offered to other investors<sup>788</sup> and by ensuring that investors have the requisite information to determine whether they are being harmed by agreements between the adviser and other

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<sup>785</sup> Proposed rules 211(h)(2)-3(a)(1) and (2).

<sup>786</sup> Proposed rule 211(h)(2)-3(b).

<sup>787</sup> *See, e.g.*, Meketa Comment Letter; Albourne Comment Letter; NEBF Comment Letter; ILPA Comment Letter I; American Association for Justice Comment Letter; AFSCME Comment Letter; Segal Marco Comment Letter; Pathway Comment Letter.

<sup>788</sup> *See* AFSCME Comment Letter; American Association for Justice Comment Letter.

investors.<sup>789</sup> Some commenters opposed the proposed rule.<sup>790</sup> Some commenters, including fund investors, expressed concern that it would curtail their ability to enter into side letters because advisers may refuse to offer certain provisions.<sup>791</sup> One commenter noted that this could negatively impact smaller investors because they would not be able to “piggy back” off of certain provisions negotiated by larger investors.<sup>792</sup> Some commenters also expressed concern that requiring advisers to determine whether a provision has a material, negative effect on other investors may cause advisers to assert regulatory risk as a way to justify the adviser’s rejection of fund terms required by applicable law, rule, or regulation for public pension funds.<sup>793</sup>

After considering comments, we are adopting the preferential treatment rule in a modified form.<sup>794</sup> First, we are adopting the prohibition on certain preferential redemption rights partly as proposed, but with two exceptions: (i) for redemptions required by applicable law, rule, regulation, or order of certain governmental authorities and (ii) if the adviser has offered the same redemption ability to all existing investors and will continue to offer the same redemption ability to all future investors in the private fund or similar pool of assets. These exceptions are designed to address commenters’ concerns that the rule would curtail their ability to secure important side letter provisions, especially ones required by applicable law. We also believe that the exception for terms offered to all investors will continue to allow smaller investors to benefit

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<sup>789</sup> See United for Respect Comment Letter I; Healthy Markets Comment Letter I.

<sup>790</sup> See AIC Comment Letter I; CCMR Comment Letter II; NYC Bar Comment Letter II; IAA Comment Letter II; ICM Comment Letter; Dechert Comment Letter; Comment Letter of Tech Council Ventures (June 14, 2022); Proof Comment Letter; NVCA Comment Letter; Canada Pension Comment Letter.

<sup>791</sup> See NYC Comptroller Comment Letter; NY State Comptroller Comment Letter; Thin Line Capital Comment Letter; OPERS Comment Letter.

<sup>792</sup> See Ropes & Gray Comment Letter.

<sup>793</sup> See NY State Comptroller Comment Letter; OPERS Comment Letter; SIFMA-AMG Comment Letter I.

<sup>794</sup> Final rule 211(h)(2)-3.

from rights negotiated by larger investors, such as different share classes offering different redemption terms. Second, we are adopting the prohibition on preferential information rights about portfolio holdings or exposures, but with an exception where the adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time. In response to commenters, this exception should allow advisers to discuss their portfolio holdings during investor meetings so long as all investors have access to the same information. Third, we are limiting the advance written notice requirement to prospective investors to apply only to material economic terms. We are still requiring advisers to provide to current investors comprehensive, annual disclosure of all preferential treatment provided by the adviser or its related persons since the last annual notice.

However, in a change from the proposal, the final rule requires the adviser to distribute to current investors a written notice of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund (i) for an illiquid fund, as soon as reasonably practicable following the end of the fund’s fundraising period and (ii) for a liquid fund, as soon as reasonably practicable following the investor’s investment in the private fund. Fourth, we are changing the defined term “substantially similar pool of assets” to “similar pool of assets” as used throughout the preferential treatment rule so that the term better reflects the breadth of the definition. Fifth, we are revising the rule text to apply the disclosure obligations in final rule 211(h)(2)-3(b) to all preferential treatment, including any preferential treatment granted in accordance with final rule 211(h)(2)-3(a). We discuss each of these changes and provisions below.

Under section 211(h)(2) of the Advisers Act, the Commission shall examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of

interest, and compensation schemes for investment advisers that the Commission deems contrary to the public interest and the protection of investors. Our staff has examined private fund advisers to assess both the investor protection risks presented by their business models in terms of compensation schemes, conflicts of interest, and sales practices and the firms' compliance with their existing legal obligations. As discussed below, the Commission deems granting preferential treatment a sales practice and conflict of interest under section 211(h)(2), that is contrary to the public interest and the protection of investors and is restricting the practice and conflict by (i) prohibiting investment advisers from providing certain preferential treatment that the adviser reasonably expects to have a material negative effect on other investors and (ii) requiring investment advisers to disclose any other preferential treatment to prospective and current investors. We believe these activities give advisers an incentive to place their interests ahead of their clients' (and, by extension, their investors'), and can result in private funds and their investors, particularly smaller investors that are not able to negotiate preferential deals with the adviser and its related persons, being misled, deceived, or otherwise harmed.

Granting preferential treatment is a conflict of interest because advisers have economic and/or other business incentives to provide preferential terms to one or more investors (*e.g.*, based on the size of the investor's investment, the ability of the investor to provide services to the adviser, or the potential to establish or cultivate relationships that have the potential to provide benefits to the adviser). These incentives have the potential to cause the adviser to provide preferential terms to one or more investors that harm other investors or otherwise put the other investors at a disadvantage. For example, 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. There may be cases where preferential information may be reasonably expected to have a material, negative effect on other investors in the fund even when the preferred investor does not have the ability to redeem its interest in the fund, and so whether preferential information violates the final rule requires a facts and circumstances analysis. For example, a private fund may make an investment into an asset with certain trading restrictions, and then later receive notice that the investment is underperforming. If the private fund gives that information to a preferred investor before others, the preferred investor could front-run other investors in taking a (possibly synthetic) short position against the asset, driving its price down, and causing losses to other investors in the fund. An adviser could also operate multiple funds with overlapping investments but offer redemption rights only for one fund containing its preferred investors. An adviser granting preferential information to certain investors in its less liquid fund, which those preferred investors could use to redeem their interests in the more liquid fund, could harm the investors in the less liquid fund even though the preferred investors do not have redemption rights in the less liquid fund.

Granting preferential treatment also involves a sales practice under section 211(h)(2) of the Advisers Act. Advisers typically attract preferred, strategic, or large investors to invest in the fund by offering preferential terms as part of negotiating with those investors. The adviser typically enters into a separate agreement, commonly referred to as a "side letter," with the particular investor in connection with such investor's admission to a fund. Side letters have the effect of establishing rights, benefits, or privileges under, or altering the terms of, the private fund's governing agreement, which advisers offer to certain prospective investors to secure their

investments in the private fund. Because advisers induce investors to invest in the private fund based on those rights, benefits, or privileges, the practice of granting preferential treatment is a sales practice under section 211(h)(2).

The practice of granting certain preferential treatment (or, in some cases, granting preferential treatment without sufficient disclosure) is contrary to the public interest and the protection of investors because it can harm, mislead, or deceive other investors. For example, to the extent an investor has negotiated limitations on its indemnification obligations, other investors may be required to bear an increased portion of indemnification costs. As another example, to the extent an investor negotiates to limit its participation in a particular investment, the aggregate returns realized by other investors could be more adversely affected than otherwise by the unfavorable performance of such investment. Moreover, other investors will have a larger position in such investment and, as a result, their holdings will be less diversified.

Like the proposed rule, the final rule includes a prohibitions component and a disclosure component that address activity across the spectrum of preferential treatment. We recognize that advisers provide a range of preferential treatment, some of which does not necessarily have a material, negative effect on other fund investors. In this case, we believe that disclosure effectively addresses our concerns related to this practice because transparency will provide investors with helpful information they otherwise may not receive. Investors can use this information to protect their interests, including through negotiations regarding new investments and re-negotiations regarding existing investments, and make more informed business decisions. For example, an investor could seek to limit its liability or otherwise negotiate an expense cap if it knows that other investors have been granted similar rights by the adviser. In addition to informing current decisions, investors can use this information to inform future investment

decisions, including how to invest other assets in their portfolio, whether to invest in private funds managed by the adviser or its related persons in the future, and, for a liquid fund, whether to redeem or remain invested in the private fund. We are concerned that an adviser's current sales practices often do not provide all investors with sufficient detail regarding preferential terms granted to other investors so that these investors can protect their interests and make informed decisions. We believe that disclosure of preferential treatment is necessary to guard against deceptive practices because it will ensure that investors have access to information necessary to diligence the prospective investment and better understand whether, and how, such terms affect the private fund overall.

Other types of preferential treatment, however, have a material, negative effect on other fund investors or investors in a similar pool of assets. We are prohibiting these types of preferential treatment because they involve sales practices and conflicts of interest that are contrary to the public interest and protection of investors. These practices are contrary to the public interest because they have the potential to harm private funds and their investors, which include, among other investors, public and private pension plans, educational endowments, non-profit organizations, and high net worth individuals.<sup>795</sup> In addition, these practices are further contrary to the protection of investors to the extent that advisers stand to profit from advantaging a subset of investors over the broader group of investors. For example, in granting preferential terms to large investors as a way of inducing their investment in the fund, the adviser stands to benefit because its fees increase as fund assets under management increase. Further, in negotiating preferential terms with prospective investors, the interests of the adviser are not necessarily aligned with those of the fund or the fund's existing investors. This results in a

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<sup>795</sup> See *supra* section I (discussing pension plan assets invested in private funds).



conflict between the adviser's interests in seeking to secure the investment, on the one hand, and the interests of the fund (and its investors) to help ensure that the terms provided to a prospective investor do not harm the fund or its existing investors, on the other hand.

Section 206(4) of the Advisers Act also authorizes the Commission to adopt rules and regulations that “define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.”<sup>796</sup> We have observed instances of advisers granting preferential treatment to an investor or a group of investors in a way that directly favors the adviser's interest or seeks to win favor with the preferred investor in hopes of inducing the preferred investor to take a certain action desired by the adviser to the detriment of other investors.<sup>797</sup> For example, we have charged an adviser for engaging in fraud by secretly offering certain investors preferential redemption and liquidity rights in exchange for those investors' agreement to vote in favor of restricting the redemption rights of the fund's other investors and by concealing this arrangement from the fund's directors and other investors.<sup>798</sup> We have also charged an adviser for engaging in fraud by contravening the fund's governing documents regarding liquidation and allowing preferred investors to exit the fund at the then current fair value in exchange for an agreement to invest in a similar fund offered by the adviser.<sup>799</sup> In another example, we have charged an adviser for engaging in fraud by improperly failing to write down the value of a hedge fund's private placement investments, even after some of those companies had declared bankruptcy, while simultaneously allowing

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<sup>796</sup> Section 206(4) of the Advisers Act.

<sup>797</sup> See *In the Matter of Aria Partners GP, LLC*, Investment Advisers Release No. 4991 (Aug. 22, 2018) (settled action); *Harbinger Capital*, *supra* footnote 60; *SEC v. Joseph W. Daniel*, Litigation Release No. 19427 (Oct. 13, 2005) (settled action); *In the Matter of Schwendiman Partners, LLC*, Investment Advisers Act Release Nos. 2083 (Nov. 21, 2002) and 2043 (July 11, 2002) (settled action).

<sup>798</sup> See *Harbinger Capital*, *supra* footnote 60.

<sup>799</sup> See *In the Matter of Schwendiman Partners, LLC*, *supra* footnote 797.

certain investors to redeem their shares in the hedge fund based on those inflated valuations.<sup>800</sup> These cases typically involve the adviser concealing its conduct by acting in contravention of the private fund's governing documents or the adviser's policies and procedures<sup>801</sup> and by failing to disclose its conduct to other investors or a fund governing body.<sup>802</sup> These side arrangements with preferred investors may also financially benefit the adviser, leaving the remaining investors to bear the costs and market risk of any remaining assets in the fund.<sup>803</sup> Thus, this practice of granting an investor in a private fund the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors is fraudulent and deceptive.

The final rule applies to preferential treatment provided through various means, including written side letters. Side letters or side arrangements are generally agreements among the investor, general partner, adviser, and/or the private fund that provide the investor with different or preferential terms than those set forth in the fund's governing documents. Side letters generally grant more favorable rights and privileges to certain preferred investors (*e.g.*, seed investors, strategic investors, those with large commitments, and employees, friends, and family) or to investors subject to government regulation (*e.g.*, ERISA, BHCA, or public records laws). The final rule also applies even if the preferential treatment is provided indirectly, such as by an adviser's related persons, because granting of preferential treatment also has the potential to harm the fund and its investors when performed indirectly. For example, the rule applies when

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<sup>800</sup> See *SEC v. Joseph W. Daniel*, *supra* footnote 797.

<sup>801</sup> See, *e.g.*, *In the Matter of Aria Partners GP, LLC*, *supra* footnote 797.

<sup>802</sup> See, *e.g.*, *Harbinger Capital*, *supra* footnote 60.

<sup>803</sup> See *Harbinger Capital*, *supra* footnote 60; see also *In the Matter of Schwendiman Partners, LLC*, *supra* footnote 797.

the adviser's related person is the general partner (or similar control person) and is a party (and/or caused the private fund to be a party, directly or indirectly) to a side letter or other arrangement with an investor, even if the adviser itself (or any related person of the adviser) is not a party to the side letter or other arrangement. The final rule will still apply under those circumstances because it prohibits an adviser from providing preferential treatment *directly or indirectly*.

We are adopting the preferential treatment rule because all investors would benefit from information regarding the preferred terms granted to other investors in the same private fund (e.g., seed investors, strategic investors, those with large commitments, and employees, friends, and family) because, in some cases, these terms disadvantage certain investors in the private fund, impact the adviser's decision making (e.g., by altering or changing incentives for the adviser), or otherwise impact the terms of the private fund as a whole. This new rule will help investors better understand marketplace dynamics and potentially improve efficiency for future investments, for example, by expediting the process for reviewing and negotiating fees and expenses. This has the potential to reduce the cost of negotiating the terms of future investments.<sup>804</sup>

Except in limited circumstances, the final rule prohibits preferential information and redemption terms when the adviser reasonably expects the terms to have a material, negative effect. Some commenters argued that the "adviser reasonably expects" standard is unworkable because an adviser cannot predict how others will react to information<sup>805</sup> and the adviser's

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<sup>804</sup> See *infra* sections VI.D.4 and VI.E.

<sup>805</sup> See Haynes & Boone Comment Letter.

decisions will be judged in hindsight.<sup>806</sup> Other commenters suggested only applying the prohibition when the adviser “knows” the preferential treatment will have a material, negative effect or imposing a good faith standard.<sup>807</sup> As proposed, we are adopting the rule with the “reasonably expects” standard, which imposes an objective standard that takes into account what the adviser reasonably expected at the time. This standard is designed to facilitate the effective operation of the rule and to help ensure that preferential treatment granted to one investor does not have deleterious effects on other investors. We were not persuaded by commenters that argued the standard is unworkable because an adviser cannot predict how others will react to information. This standard does not require advisers to make such predictions; rather, it requires advisers to form only a reasonable expectation based on the facts and circumstances. We were also not persuaded by commenters that stated the standard will result in adviser’s decisions being unfairly judged in hindsight. An adviser’s actions will be judged based on the facts and circumstances at the time the adviser grants or provides the preferential treatment, as set forth in the final rule.

Other commenters asked us to provide more specificity around what constitutes a “material, negative effect,” and they stated that if advisers broadly interpret this term, then advisers could lack incentive to offer certain side letter terms to investors, including, for example, necessary investor-specific rights.<sup>808</sup> Because many side letter terms generally do not harm other investors and are not related to liquidity rights (including investor-specific provisions relating to tax, legal, regulatory, or accounting matters), we do not believe that even a broad

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<sup>806</sup> See PIFF Comment Letter.

<sup>807</sup> See AIMA/ACC Comment Letter; Dechert Comment Letter.

<sup>808</sup> See Comment Letter of Structured Finance Association (June 13, 2022) (“SFA Comment Letter II”); ILPA Comment Letter I; RFG Comment Letter II; AIMA/ACC Comment Letter; Schulte Comment Letter; Meketa Comment Letter.

interpretation of this standard would discourage advisers from offering such side letter terms to investors.

Another commenter stated that the materiality of preferential redemption terms or information rights should be assessed in the “basic framework under the securities laws (*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).”<sup>809</sup> This commenter stated that such a standard would allow the adviser to objectively assess the relevant facts and circumstances and consider both quantitative and qualitative factors in determining whether the prohibition should apply to the particular term. We believe, however, that requiring only a “materiality” standard has the potential to result in a broader prohibition than the one we proposed, and we do not believe a broader prohibition is needed to address the conduct that the rule is intended to address.<sup>810</sup>

Commenters did not offer specific examples of what types of activity or information would have a “material, negative effect,” and we believe 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. For example, we believe an adviser could form a reasonable expectation that certain redemption terms would have a material, negative effect on other fund investors if a majority of the portfolio investments were not likely to be liquid.

One commenter stated that requiring advisers to determine whether a preferential term has a material, negative effect on other “investors” suggests that advisers are required to second-

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<sup>809</sup> See AIMA/ACC Comment Letter.

<sup>810</sup> Information is material if there is a substantial likelihood that the information would have been viewed by a reasonable investor as having significantly altered the total mix of information available. See *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

guess each investor's individual circumstances rather than the impact such term has on the private fund as a whole.<sup>811</sup> This commenter argued that such a requirement runs contrary to the D.C. Circuit Court's decision in *Goldstein v. SEC*. However, the exercise of our statutory authority under sections 211(h)(2) and 206(4) is consistent with the court's ruling in *Goldstein v. SEC* because section 206(4) is not limited in its application to "clients" and section 211(h) by its terms provides protection to "investors." A plain interpretation of the statute supports a reading that the provision authorizes the Commission to promulgate rules to directly protect investors generally (rather than only the clients) and does not contradict the court's ruling in *Goldstein v. SEC*.<sup>812</sup>

### **1. Prohibited Preferential Redemptions**

We proposed to prohibit a private fund adviser from, directly or indirectly, granting an investor in the private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.<sup>813</sup>

One commenter stated that the proposed prohibition on preferential redemption terms would establish helpful baseline protections for all investors, including those who cannot negotiate for sufficient protections<sup>814</sup> due to bargaining power dynamics or lack of information or resources. One commenter stated that this provision would protect remaining fund investors who could find themselves invested in a materially different portfolio after other, preferred

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<sup>811</sup> See SIFMA-AMG Comment Letter I.

<sup>812</sup> See *supra* section I (Introduction and Background).

<sup>813</sup> Proposed rule 211(h)(2)-3(a)(1).

<sup>814</sup> See ICCR Comment Letter.

investors redeemed.<sup>815</sup> Other commenters stated that the prohibition on preferential redemption terms would limit investor choice<sup>816</sup> and suggested excluding scenarios in which an investor elects to receive less liquidity in exchange for other rights or terms.<sup>817</sup> Other commenters stated that the treatment of multi-class funds is unclear under the proposed rule.<sup>818</sup> They expressed concern that the prohibition would result in less liquidity for investors<sup>819</sup> and that investors should be permitted to negotiate favorable liquidity terms since those investors might also negotiate other liquidity terms that benefit all investors.<sup>820</sup> Some commenters recommended that we not move forward with the proposed prohibition<sup>821</sup> and instead require disclosure of preferential liquidity terms.<sup>822</sup> These commenters stated that a disclosure-based regime would be more consistent with market practice,<sup>823</sup> and it would avoid unintended consequences, such as blanket bans on liquidity rights granted due to certain laws (*e.g.*, the U.S. Employee Retirement Income Security Act of 1974).<sup>824</sup>

We understand, based on staff experience, that preferential terms provided to certain investors or one investor do not necessarily benefit the fund or other investors that are not party to the side letter agreement and, at times, we believe these terms can have a material, negative

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<sup>815</sup> See United for Respect Comment Letter I.

<sup>816</sup> See SBAI Comment Letter; MFA Comment Letter I.

<sup>817</sup> See MFA Comment Letter I.

<sup>818</sup> See Comment Letter of Curtis (Apr. 25, 2022) (“Curtis Comment Letter”); PIFF Comment Letter.

<sup>819</sup> See PIFF Comment Letter; Comment Letter of the Regulatory Fundamentals Group (Dec. 3, 2022) (“RFG Comment Letter III”).

<sup>820</sup> See Ropes & Gray Comment Letter; RFG Comment Letter III.

<sup>821</sup> See NYC Comptroller Comment Letter; AIMA/ACC Comment Letter; IAA Comment Letter II.

<sup>822</sup> See SBAI Comment Letter; NYC Bar Comment Letter II; RFG Comment Letter III; Ropes & Gray Comment Letter; PIFF Comment Letter.

<sup>823</sup> See Ropes & Gray Comment Letter.

<sup>824</sup> See PIFF Comment Letter; NYC Bar Comment Letter II; IAA Comment Letter II.

effect on other investors.<sup>825</sup> For example, selective disclosure of certain information may entitle the investor privy to such information to avoid a loss (e.g., by submitting a redemption request) at the expense of the non-privy investors.

After considering comments, we are adopting the prohibition on certain preferential redemption terms, but with two exceptions. In general, we believe that granting preferential liquidity rights on terms that the adviser reasonably expects to have a material, negative effect on other investors in the private fund or in a similar pool of assets is a sales practice that is harmful to the fund and its investors. An adviser can attract preferred investors to invest in the fund by offering preferential terms, such as more favorable liquidity rights.<sup>826</sup> Such practices often have conflicts of interest, however, that can harm other investors in the private fund. For example, in granting preferential liquidity rights to a large investor, the adviser stands to benefit because its fees increase as fund assets under management increase. While the fund also may experience some benefits, including the ability to attract additional investors and to spread expenses over a broader investor and asset base and the ability to raise sufficient capital to implement the fund's investment strategy and complete investments that meet the fund's target investment size (particularly for illiquid funds), there are scenarios where the preferential liquidity terms harm the fund and other investors. For example, if an adviser allows a preferred investor to exit the fund early and sells liquid assets to accommodate the preferred investor's redemption, the fund may be left with a less liquid pool of assets, which can inhibit the fund's ability to carry out its investment strategy or promptly satisfy other investors' redemption requests. This can dilute remaining investors' interests in the fund and make it difficult for those investors to mitigate

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<sup>825</sup> See, e.g., EXAMS Private Funds Risk Alert 2020, *supra* footnote 188.

<sup>826</sup> See, e.g., *id.* (Commission staff has observed advisers provide side letter terms to certain investors, including preferential liquidity terms).



their investment losses in a down market cycle.<sup>827</sup> These concerns can also apply when an adviser provides favorable redemption rights to an investor in a similar pool of assets, such as another feeder fund investing in the same master fund. The Commission believes that the potential harms to other investors justify this restriction.

In a change from the proposal, and after considering comments, we are adopting two exceptions from this prohibition. First, an adviser is not prohibited from offering preferential redemption rights if the investor is required to redeem due to applicable laws, rules, regulations, or orders of any relevant foreign or U.S. Government, State, or political subdivision to which the investor, private fund, or any similar pool of assets is subject. Commenters suggested that, if we retain the rule, we should permit an exclusion from this rule with respect to investors that are required to obtain such liquidity terms because of regulations and laws (*i.e.*, institution-specific requirements).<sup>828</sup> Some commenters argued that this exception is necessary to prevent the fund or investors from suffering harm related to legal or regulatory issues<sup>829</sup> (*e.g.*, certain investors may require special redemption rights to comply with pay-to-play laws) and to ensure that certain investors, such as pension plans, can continue to invest in private funds.<sup>830</sup> We do not intend for this prohibition to result in the exclusion of certain investors from funds or in an investor violating other applicable laws. For example, under this exception, pension plan subject

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<sup>827</sup> See *In the Matter of Deccan Value Investors LP, et al.*, Investment Advisers Act Release No. 6079 (Aug. 3, 2022) (settled action) (alleging that registered investment adviser mismanaged significant redemptions by two university clients due in part to the adviser's stated concern over the negative impact the redemptions could have on non-redeeming clients and investors).

<sup>828</sup> See NYC Comptroller Comment Letter; SIFMA-AMG Comment Letter I; OPERS Comment Letter; RFG Comment Letter III; AIC Comment Letter II.

<sup>829</sup> See Chamber of Commerce Comment Letter; RFG Comment Letter III; MFA Comment Letter I; Ropes & Gray Comment Letter; Dechert Comment Letter; PIFF Comment Letter; SIFMA-AMG Comment Letter I; Comment Letter of the Minnesota State Board of Investment (Apr. 25, 2022); OPERS Comment Letter; NYC Bar Comment Letter II; Meketa Comment Letter; SIFMA-AMG Comment Letter I.

<sup>830</sup> See, *e.g.*, Ropes & Gray Comment Letter; OPERS Comment Letter; RFG Comment Letter II.

to State or local law may be required to redeem its interest under certain circumstances, such as a violation by the adviser of State pay-to-play, anti-boycott, or similar laws. Advisers that use this exception will still be subject to the disclosure obligations under rule 211(h)(2)-3(b). For example, with respect to a pension plan that receives preferential redemption rights under this exception, an adviser will need to disclose this preferential treatment pursuant to rule 211(h)(2)-3(b). Certain commenters suggested that we broaden the exception to include redemptions pursuant to an investor's policies or resolutions.<sup>831</sup> We are concerned, however, that excluding redemptions pursuant to these more informal arrangements could compromise the investor protection goals of the rule and would incentivize investors to adopt policies or resolutions to circumvent the rule. We also believe that any exception from this rule should be narrowly tailored to limit potential harms to other investors to those cases that are absolutely necessary. We believe that redemption terms required by more informal arrangements, such as policies or resolutions, would therefore not be permissible. Accordingly, the final rule does not provide an exception for more informal arrangements, such as policies and resolutions.

Second, an adviser is not prohibited from offering preferential redemption rights if the adviser has offered the same redemption ability to all other existing investors and will continue to offer such redemption ability to all future investors in the same private fund or any similar pool of assets. Several commenters supported giving investors a choice of various liquidity options and disclosing this in the fund's governing and offering documents.<sup>832</sup> We understand that advisers have many methods to provide different liquidity terms to private fund investors,

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<sup>831</sup> See e.g., NY State Comptroller Comment Letter (stating that investor policies applied consistently across similar investments should be excepted); NYC Comptroller Comment Letter (stating that investor policies requiring different liquidity terms should be excepted).

<sup>832</sup> See AIMA/ACC Comment Letter; RFG Comment Letter III; NACUBO Comment Letter; MFA Comment Letter I; SBAI Comment Letter; SIFMA-AMG Comment Letter I; Segal Marco Comment Letter.

including through side letters as well as by embedding these terms in the fund's governing documents.<sup>833</sup> While preferential liquidity terms provided via side letter are more explicitly targeted to particular investors, we believe that favorable liquidity terms provided through the fund's governing documents (*i.e.*, by a fund offering different share classes, some with more favorable liquidity terms than others) presents the same concerns that our final rule seeks to address. Overall, we believe that this exception balances our policy goals of protecting against potential fraud and deception and certain conflicts of interest, while preserving investor choice regarding liquidity and price. To qualify for the exception, an adviser must have offered the same redemption ability to *all* other existing investors and must continue to offer such redemption ability to all future investors *without qualification* (*e.g.*, no commitment size,<sup>834</sup> affiliation requirements, or other limitations). For example, an adviser offering a fund with three share classes, each with different liquidity options but that are otherwise subject to the same terms (Class A, Class B, and Class C), cannot restrict Class A to friends and family investors if the adviser reasonably expects such liquidity rights to have a material, negative effect on other investors.

Advisers are prohibited from acting directly or indirectly under the final rule.<sup>835</sup> For example, an adviser could not avail itself of the exception by offering Class A (annual redemption, 1% management fee, 15% performance fee) and Class B (quarterly redemption, 1.5% management fee, 20% performance fee) while requiring Class B investors also to invest in

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<sup>833</sup> This exception acknowledges that investors may prioritize one term over another (*e.g.*, an investor may be willing to pay higher fees in exchange for better liquidity). Thus, we believe that this exception is responsive to commenters who stated that the Commission should provide an exception for scenarios in which an investor elects to receive less liquidity in exchange for other rights or terms.

<sup>834</sup> An adviser could not avail itself of this exception, for example, if it offered a share class that is only available to investors that meet a certain minimum commitment size.

<sup>835</sup> *See* rule 211(h)(2)-3.

another fund managed by the adviser, to the extent the adviser reasonably expects such liquidity terms would have a material, negative effect on other investors. We would interpret such an incentive structure as failing to satisfy the requirement to offer investors the same redemption ability as required under the final rule because the obligation to invest in another fund managed by the adviser serves to indirectly prevent investors from selecting Class B. We similarly would interpret an arrangement where Class B investors (quarterly redemption, 1.5% management fee, 20% performance fee) would be required to agree to uncapped liability when the adviser has reason to believe that certain investors (*e.g.*, government entities) cannot agree to uncapped liability, while Class A investors would not be subject to such an obligation, as not satisfying the requirements of the exception.

## **2. Prohibited Preferential Transparency**

We proposed to prohibit an adviser and its related persons from providing information regarding the portfolio holdings or exposures of the private fund or of a substantially similar pool of assets to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.<sup>836</sup>

Some commenters supported the proposal,<sup>837</sup> and one commenter stated that all investors should receive basic information about portfolio holdings.<sup>838</sup> Others argued that the proposed rule could negatively impact investors to the extent it would prohibit them from receiving

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<sup>836</sup> Proposed rule 211(h)(2)-3(a)(2).

<sup>837</sup> See Comment Letter of Pattern Recognition: A Research Collective (Apr. 25, 2022) (“Pattern Recognition Comment Letter”); Segal Marco Comment Letter.

<sup>838</sup> See Pattern Recognition Comment Letter.

information required under applicable laws or regulations.<sup>839</sup> Certain commenters argued that the proposed rule could harm investors if they are prohibited from receiving certain information or material as members of the fund’s limited partner advisory committee.<sup>840</sup> As with the proposed prohibition on preferential liquidity, some commenters recommended that we not move forward with this prohibition and instead allow preferential information rights, if they are disclosed to other investors.<sup>841</sup>

We have decided to adopt the prohibition on certain preferential transparency as proposed but with an exception that is discussed below. We continue to believe that selective disclosure of portfolio holdings or exposures can result in profits or avoidance of losses among those who were privy to the information beforehand at the expense of investors who did not benefit from such transparency. In addition, providing such information in a fund with redemption rights could enable an investor to trade in a way that “front-runs” or otherwise disadvantages the fund or other clients of the adviser. Granting preferential transparency if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets, for example through side letters, is contrary to the public interest and protection of investors because it preferences one investor at the expense of another. For example, if an adviser provides preferential information about a hedge fund’s holdings to one investor as opposed to another investor, the investor with preferential information may use that information to redeem from the hedge fund during the next redemption cycle, even if both investors have the same redemption rights. In addition, an adviser

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<sup>839</sup> See Meketa Comment Letter; MFA Comment Letter I.

<sup>840</sup> See NYC Comptroller Comment Letter; NY State Comptroller Comment Letter; RFG Comment Letter II.

<sup>841</sup> See NYC Bar Comment Letter II; SBAI Comment Letter.

can have a conflict of interest that may cause it to agree to provide preferential information rights to a certain investor in exchange for something of benefit to the adviser. For example, an adviser may agree to offer preferential terms to a large financial institution that agrees to provide services to the adviser. The rule is designed to neutralize the potential for private fund advisers to treat portfolio holdings information as a commodity to be used to gain or maintain favor with particular investors.<sup>842</sup>

Selective disclosure to certain parties is a fundamental concern often prohibited or restricted under other Federal securities laws. For example, the Commission adopted Regulation FD to address selective disclosure by certain issuers of material nonpublic information under the Exchange Act. The Commission stated that selective disclosure occurs when issuers release material nonpublic information about a company to selected persons, such as securities analysts or institutional investors, before disclosing the information to the general public.<sup>843</sup> This practice undermines the integrity of the securities markets – both public and private – and reduces investor confidence in the fairness of those markets.<sup>844</sup>

Many commenters stated that the proposed rule would have a chilling effect on ordinary course investor communications<sup>845</sup> and that it was unclear whether the proposed rule would apply only to formal communications (*e.g.*, side letters, other written communications) or whether informal communications (*e.g.*, oral statements,<sup>846</sup> such as phone conversations) would

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<sup>842</sup> See Selective Disclosure and Insider Trading, Securities Act Release No. 7881 (Aug. 15, 2000) [65 FR 51715 (Aug. 24, 2000)].

<sup>843</sup> See *id.*

<sup>844</sup> See *infra* section VI.D.4.

<sup>845</sup> See MFA Comment Letter I; Haynes & Boone Comment Letter; Dechert Comment Letter; RFG Comment Letter II; AIMA/ACC Comment Letter.

<sup>846</sup> See RFG Comment Letter II.

be included.<sup>847</sup> Because advisers might fear liability under the proposed rule, commenters stated that an outright prohibition on preferential transparency might prevent advisers from providing investors with important information desired by investors or, in some instances, required by investors because of the operation of a law, rule, regulation, or order.<sup>848</sup> Commenters also expressed concern regarding a lack of clarity under the “material, negative effect” standard.<sup>849</sup> We have considered these concerns in adopting the rule. While we understand commenter concerns that this prohibition could chill adviser/investor communications, the rule serves a compelling government interest in protecting all investors not just some investors, ensuring confidence in the fairness and integrity of our capital markets, and addressing conflicts of interest in private fund structures, which have been historically opaque. We also believe that the rule is closely drawn because it applies only in a narrow set of circumstances: when the adviser reasonably expects that providing information would have a material, negative effect on other investors in the private fund or similar pool of assets.<sup>850</sup> Any preferential information that does not meet this criterion would only be subject to the disclosure portions of this rule.<sup>851</sup>

In addition, any chilling effect is further reduced as, in a change from the proposal, we are adopting an exception to this prohibition for preferential information made broadly available by the adviser. Specifically, the rule states that an adviser is not prohibited from providing preferential information if the adviser offers such information to all existing investors in the private fund and any similar pool of assets at the same time or substantially the same time.

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<sup>847</sup> See MFA Comment Letter I; AIMA/ACC Comment Letter.

<sup>848</sup> See Dechert Comment Letter; RFG Comment Letter II.

<sup>849</sup> See Dechert Comment Letter; Haynes & Boone Comment Letter.

<sup>850</sup> We are clarifying that the final rule applies to all types of communications: formal and informal as well as written, visual, and oral.

<sup>851</sup> See final rule 211(h)(2)-3(b).

Although the disclosure-based exception we are adopting is not identical to commenters' suggestions, we believe the final rule is responsive to suggestions that the rule should be disclosure based rather than prohibition based.<sup>852</sup>

As discussed above, we agree with commenters that it is important for investors to be able to continue to receive information and, without an exception, they may not be able to do so under the proposed rule. As a result, the exception requires that when an adviser discloses otherwise prohibited information to one investor, it must also provide such information to all investors. This is designed to help ensure that investors are treated fairly and that investors have equal access to the same information. We believe that this exception balances our policy goals while preserving the ability for investors to access information that is important to their investment decisions. To qualify for the exception, an adviser must offer the information to all other investors at the same time or substantially the same time. For example, an adviser could provide, to one current investor, ESG data related to a specific portfolio company that the private equity fund holds only if the adviser offers that same information to all other investors in the private equity fund and any similar pools of assets. To qualify for the exception, the adviser must offer to provide the information to other investors at the same time or substantially the same time.

As with the redemptions prohibition, some commenters requested that we provide an exception from this prohibition for preferential information that an investor must obtain as a requirement of State or other law.<sup>853</sup> We do not believe it is necessary to grant such an exception

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<sup>852</sup> See SBAI Comment Letter; Schulte Comment Letter.

<sup>853</sup> See NY State Comptroller Comment Letter; CalPERS Comment Letter; Predistribution Initiative Comment Letter II; Ropes & Gray Comment Letter; PIFF Comment Letter; NYC Comptroller Comment Letter; AIMA/ACC Comment Letter; NY State Comptroller Comment Letter; IAA Comment Letter II.



because advisers can now rely on the exception discussed above by offering to disclose information to all investors. This ensures that investors can still obtain necessary information, whether required by law or contract, without sacrificing the policy goals of the rule. We also believe that State laws generally require disclosure of information that would not have a material, negative effect on other investors, such as fee and expense transparency.<sup>854</sup>

The prohibition is narrowly drawn in that it applies only to preferential information that would have a material, negative effect on other investors in that private fund or in a similar pool of assets. Commenters suggested that the preferential treatment rule should apply only to open-end funds because the redemption ability in the open-end fund structure makes it more likely for preferential information rights to materially harm other investors.<sup>855</sup> We agree that is easier to trigger the material, negative effect provision in a scenario where certain investors receive preferential information *and* an ability to redeem their interests because those investors can exit the fund sooner than others, potentially harming remaining investors. As a result, the ability to redeem is an important part of determining whether providing information would have a material, negative effect on other investors and thus whether an adviser triggers the preferential information prohibition. We 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. We do not believe, however, that a blanket exemption for all closed-end funds would be appropriate because, for example, even closed-end funds offer redemption rights in certain

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<sup>854</sup> See, e.g., section 7514.7 of the California Government Code. This law requires California public investment funds to disclose certain information annually in a report presented at a meeting open to the public, such as the fees and expenses that the California public investment fund paid directly to the alternative investment vehicle; the California public investment fund's pro rata share of carried interest distributed to the fund manager or related parties; and the California public investment fund's pro rata share of aggregate fees and expenses paid by all of the portfolio companies held within the alternative investment vehicle to the fund manager or related parties.

<sup>855</sup> See NY State Comptroller Comment Letter; Top Tier Comment Letter.

extraordinary circumstances. Whether preferential information provided to an investor in a closed-end fund violates the final rule requires a facts and circumstances analysis.

### 3. Similar Pool of Assets

We proposed to define the term “substantially similar pool of assets” as a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons.<sup>856</sup>

We are adopting the definition as proposed, but we are changing the defined term to “similar pool of assets” so that the defined term better reflects the broad scope of the definition.<sup>857</sup> This conforming change is appropriate because we believe that, depending on the facts and circumstances, the definition will likely capture vehicles outside of what the private funds industry would typically view as “substantially similar pools of assets.” 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. Thus, we believe the appropriate term to use is “similar,” rather than substantially similar pool of assets.

We are also excluding securitized asset funds from the definition of similar pool of assets. We believe that this change is appropriate because, as discussed above, we believe that certain distinguishing structural and operational features of SAFs have prevented or deterred

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<sup>856</sup> Proposed rule 211(h)(1)-1.

<sup>857</sup> In the marketing rule, we defined the term “related portfolio” to mean “a portfolio with substantially similar investment policies, objectives, and strategies...” (emphasis added). In this final rule, the scope of similar pool of assets is broader because the term includes a pooled investment vehicle with “substantially similar investment policies, objectives, or strategies...” (emphasis added). We are removing the word “substantially” from the defined term in order to signal the broader scope. See rule 206(4)-1I(15) under the Advisers Act.

SAF advisers from engaging in the type of conduct that the final rules seek to address, such as the granting of preferential treatment.

We believe the final definition provides the appropriate scope to address our concerns, which include an adviser providing more favorable terms to investors in another similar pool of assets to the detriment of private fund investors.<sup>858</sup> A comprehensive definition of “similar pool of assets” will help prevent advisers from attempting to structure around the preferential treatment prohibitions by, for example, creating parallel funds solely for investors with preferential terms.

Whether a pool of assets managed by the adviser is “similar” to the private fund requires a facts and circumstances analysis. A pool of assets with a materially different target return or sector focus, for example, would likely not have substantially similar investment policies, objectives, or strategies to those of the subject private fund, depending on the facts and circumstances.

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. It would also include pooled vehicles with different base currencies and pooled vehicles with embedded leverage to the extent such pooled vehicles have substantially similar investment policies, objectives, or strategies as those of the subject private fund. In addition, an adviser would be required to consider whether its proprietary vehicles meet the definition of “similar pool of assets.” We believe this scope is appropriate, and we note our staff

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<sup>858</sup> See, e.g., Proposing Release, *supra* footnote 3, at 168.

also has observed scenarios where an adviser establishes investment vehicles that invest side-by-side along with the private fund that have better liquidity terms than the terms provided to investors in the private fund.<sup>859</sup>

This definition is designed to capture most commonly used private fund structures (or similar arrangements) and prevent advisers from structuring around the prohibitions on preferential treatment. For example, in a master-feeder structure, some advisers create custom feeder funds for favored investors. Without a broad definition of similar pool of assets, the rule would not preclude such advisers from providing preferential treatment to investors in these custom feeder funds to the detriment of investors in standard commingled feeder funds within the master-feeder structure.

Many commenters argued that the proposed definition of “substantially similar pool of assets” was overbroad and suggested that we narrow the definition.<sup>860</sup> These commenters suggested that we limit the definition to, for example, funds that invest side by side, *pari passu*, with the main fund in substantially all investment opportunities (which would, among other things, make it easier for advisers to determine their compliance obligations under the rule and prevent investors from being subject to limitations on liquidity and information rights)<sup>861</sup> and that we exclude co-investment vehicles and separately managed accounts.<sup>862</sup> In contrast, one commenter suggested broadening the proposed definition beyond pooled vehicles to include separately managed accounts because separately managed accounts can pose similar risks to

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<sup>859</sup> See EXAMS Private Funds Risk Alert 2020, *supra* footnote 188.

<sup>860</sup> See SIFMA-AMG Comment Letter I; NYC Bar Comment Letter II; ILPA Comment Letter I; AIMA/ACC Comment Letter; PIFF Comment Letter; SFA Comment Letter II; Ropes & Gray Comment Letter; Haynes & Boone Comment Letter.

<sup>861</sup> See SIFMA-AMG Comment Letter I; NYC Bar Comment Letter II; ILPA Comment Letter I; AIMA/ACC Comment Letter.

<sup>862</sup> See AIMA/ACC Comment Letter.

pooled vehicles.<sup>863</sup> This rule is designed to address the specific concerns that arise out of the lack of transparency and governance mechanisms prevalent in the private fund structure and protects underlying investors in those funds from being disadvantaged as a result of preferential treatment given to underlying investors in other similar pools because the adviser does not have a fiduciary duty to those underlying investors. It 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.” There are, however, 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.”<sup>864</sup>

Certain advisers offer existing investors, related persons, or third parties the opportunity to co-invest alongside the private fund through one or more co-investment vehicles established or advised by the adviser or its related persons.<sup>865</sup> These co-investment vehicles may be set up for one or more specific investments. Co-investment vehicles have the effect of increasing the capital available for the adviser to complete a prospective investment. Commenters expressed concern that the rule would impede the co-investment process because the rule could be interpreted to prohibit selective disclosure of portfolio holding information to investors with co-

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<sup>863</sup> See Anonymous (Mar. 2, 2022) at 1.

<sup>864</sup> See Exemptions Adopting Release, *supra* footnote 9, at 78-79.

<sup>865</sup> In some cases, advisers use co-investment opportunities to attract new investors and retain existing investors. Advisers may offer these existing or prospective investors the opportunity to invest in co-investment vehicles with materially different fee and expense terms than the main fund (*e.g.*, no fees or no obligation to bear broken deal expenses). These co-investment opportunities may raise conflicts of interest, particularly when the opportunity to invest arises because of an existing investment and the fund itself would otherwise be the sole investor.

investing rights and advisers would need to assess whether information provided to co-investors triggers the prohibition.<sup>866</sup> One commenter suggested excluding co-investment vehicles from the definition.<sup>867</sup> While we understand commenter concerns, we believe that we should adopt the definition as proposed because excluding co-investment vehicles that have substantially similar investment policies, objectives, or strategies would expose investors to similar risks that the rule is intended to address and potentially allow advisers to circumvent the rule. Co-investment vehicles operate 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. Thus, we do not believe that co-investment vehicles should be treated differently.

#### **4. Other Preferential Treatment and Disclosure of Preferential Treatment**

We proposed to prohibit other preferential terms unless the adviser provided certain written disclosures to prospective and current investors.<sup>868</sup> Specifically, we proposed to require an adviser to provide to prospective private fund investors, prior to the investor's investment in the fund, a written notice with specific information about any preferential treatment the adviser or its related persons provide to other investors in the same private fund.<sup>869</sup> We also proposed to

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<sup>866</sup> See AIC Comment Letter II; Segal Marco Comment Letter (stating that the proposed rule would require advisers to offer every co-investment opportunity to every investor, which could prevent private funds from maximizing value for investors).

<sup>867</sup> See AIMA/ACC Comment Letter.

<sup>868</sup> Proposed rule 211(h)(2)-3(b).

<sup>869</sup> Proposed rule 211(h)(2)-3(b)(1).

require advisers to distribute an annual written notice to current investors in a private fund where such notice provides specific information about any preferential treatment the adviser or its related persons provide to other investors in the same private fund since the last written notice.<sup>870</sup>

We are adopting this aspect of the rule largely as proposed because we are concerned that an adviser's current sales practices do not provide all investors with sufficient detail regarding preferential terms granted to certain investors. Increased transparency will better inform investors about the breadth of preferential treatment, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms. This disclosure will help investors understand whether, and how, such terms present conflicts of interest or otherwise impact the adviser's compensation schemes with the private fund. The disclosure will also help prevent investors from being potentially defrauded or deceived by preferential treatment that negatively impacts their investment in the private fund.<sup>871</sup>

One commenter generally opposed the disclosure portion of the preferential treatment rule because advisers may seek to deny investors certain terms to avoid being required to disclose those concessions to all investors.<sup>872</sup> One commenter asserted that the disclosure

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<sup>870</sup> Proposed rule 211(h)(2)-3(b)(2).

<sup>871</sup> As discussed above, investors can use this information to protect their interests, including through negotiations regarding new investments and renegotiations regarding existing investments, and to make more informed business decisions. We believe that disclosure of preferential treatment is necessary to guard against deceptive and/or fraudulent practices because it will increase investor access to information necessary to diligence the prospective investment and better understand whether, and how, such terms affect the private fund overall. For example, an investor could seek assurances that it will not bear more than its *pro rata* portion of expenses as a result of economic arrangements provided to other investors. As another example, disclosure of significant governance rights provided to one investor, such as the ability to terminate the investment period of the fund or remove the adviser, will guard against other investors being misled about the terms of their investment and how preferential treatment provided to certain, but not all, investors impacts those terms.

<sup>872</sup> See OPERS Comment Letter.

obligation could compromise the anonymity of investors.<sup>873</sup> Other commenters suggested narrowing the scope of the proposed rule by requiring disclosure only of *material* preferential treatment.<sup>874</sup> In contrast, some commenters supported the disclosure requirements because they said they would assist the investor in the negotiation process.<sup>875</sup>

In response to commenter concerns, we are making three changes to the proposal. First, we are limiting the advance written notice requirement to “any preferential treatment related to *any material economic terms*” rather than requiring advance disclosure of all preferential treatment. Commenters stated that the advance notice requirement would impede the closing process because it would incentivize investors to wait until the last minute to invest in order to maximize the amount of information they receive about the terms other investors negotiated.<sup>876</sup> They asserted that, because of the dynamic nature of negotiations leading up to a closing (*i.e.*, advisers simultaneously negotiate with multiple investors), it would be impractical for an adviser to provide advance written notice to a prospective investor because doing so would result in a repeated cycle of disclosure, discussion, and potential renegotiation.<sup>877</sup> Several commenters argued that the most favored nations (“MFN”) clause process addresses the policy concerns raised by the proposed rule,<sup>878</sup> and they suggested that instead of applying the rule to funds that offer MFN rights to investors, especially closed-end funds, we should allow such funds to adopt

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<sup>873</sup> See IAA Comment Letter II.

<sup>874</sup> See BVCA Comment Letter; Invest Europe Comment Letter; GPEVCA Comment Letter.

<sup>875</sup> See RFG Comment Letter II; Healthy Markets Comment Letter I.

<sup>876</sup> See AIC Comment Letter I.

<sup>877</sup> See MFA Comment Letter I; PIFF Comment Letter; Chamber of Commerce Comment Letter; AIMA/ACC Comment Letter; Correlation Ventures Comment Letter; SIFMA-AMG Comment Letter I; ATR Comment Letter; Ropes & Gray Comment Letter.

<sup>878</sup> See NY State Comptroller Comment Letter.



a best-in-class MFN process.<sup>879</sup> In an MFN clause, an adviser or its related person generally agrees to provide an investor with contractual rights or benefits that are equal to or better than the rights or benefits provided to certain other investors, subject to certain exceptions. Closed-end fund investors are typically entitled to elect these rights or benefits *after the end of the private fund's fundraising period*, and open-end fund investors are typically entitled to elect these rights or benefits *after the closing of their investment*. As a result, adopting a best-in-class MFN process would not provide prospective investors with information that they can act upon when negotiating the terms of their investment because investors would not receive such information until after the closing of their investment. Some commenters supported limiting any advance disclosure requirement to certain key terms with more comprehensive disclosure to follow post investment.<sup>880</sup>

While we understand commenter views about the timing concerns associated with advance disclosure, we believe that it is crucial for prospective investors to have access to certain information before they invest. This is designed to prevent investors from being misled because it will provide them with transparency regarding how the terms may affect their investment, how the terms may affect the adviser's relationship with the private fund and its investors, and whether the terms create any additional conflicts of interest.<sup>881</sup> To address commenter concerns about timing and impeding the closing process, the final rule will limit advance disclosure to those terms that a prospective investor would find most important and that would significantly

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<sup>879</sup> See ILPA Comment Letter I; BVCA Comment Letter; Invest Europe Comment Letter; GPEVCA Comment Letter.

<sup>880</sup> See Ropes & Gray Comment Letter; PIFF Comment Letter.

<sup>881</sup> For example, to the extent a private equity manager sought to limit or narrow the fund's overall investment strategy via a side letter provision with one investor, the other investors would likely be misled about the fund's actual investment strategy.

impact its bargaining position (*i.e.*, material economic terms, including, but not limited to, the cost of investing, liquidity rights, fee breaks, and co-investment rights<sup>882</sup>). One commenter stated that the final rule should not apply to preferential terms an adviser offers to investors and instead should apply only to preferential terms actually provided.<sup>883</sup> We agree with this interpretation of the scope of the disclosure obligations under this aspect of the rule and believe this is clear from the rule text.<sup>884</sup>

Second, we are requiring advisers to disclose all other preferential treatment, in writing, to current investors on the following timeline: for illiquid funds, as soon as reasonably practicable following the end of the private fund’s fundraising period, and for liquid funds, as soon as reasonably practicable following the investor’s investment in the private fund.<sup>885</sup> This change is in response to commenter concerns that requiring advisers to disclose all preferential treatment would impede the closing process. As a result, we are allowing advisers to wait until after an investor has invested in the fund to disclose the remaining preferential terms (*i.e.*, all preferential terms that are not material economic terms). Although investors may not receive this information until after the closing of their investment, this information will nonetheless enable investors to protect their interests more effectively and make more informed investment

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<sup>882</sup> 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.

<sup>883</sup> See AIMA/ACC Comment Letter.

<sup>884</sup> See, *e.g.*, final rule 211(h)(2)-3(b) (referring to preferential treatment “the adviser or its related persons *provide...*” (emphasis added)).

<sup>885</sup> The disclosure requirements are not limited to an investor’s initial investment in the fund. For example, if an existing investor increases its investment in the fund, the adviser is required to disclose all preferential treatment to such investor following such additional investment in accordance with the timelines set forth in the rule.

decisions with a broader understanding of market terms, including with respect to negotiations of new investments with the adviser or renegotiations (or liquidations, if applicable) of existing investments. This change also addresses a commenter’s suggestion that any final rule account for the different negotiating processes for open-end and closed-end funds.<sup>886</sup>

An example of preferential treatment that the final rule prohibits unless it is disclosed post investment and/or pursuant to the annual notice requirement is if an adviser to a private equity fund provides “excuse rights” (*i.e.*, the right to refrain from participating in a specific investment the private fund plans to make) to certain private fund investors.<sup>887</sup> We believe that post-investment and annual disclosure is important because it helps investors learn whether other investors are receiving a better or different deal and whether any such arrangements pose potential conflicts of interest, potential harms, or other disadvantages (*e.g.*, to the extent other investors are excused from participating in certain types of investments, such as alcohol-related investments, the participating investors may become over concentrated in such investments).

Third, we are revising the rule text to apply the disclosure obligations in final rule 211(h)(2)-3(b) to all preferential treatment, including any preferential treatment granted in accordance with final rule 211(h)(2)-3(a). Specifically, we are removing the reference to “other” from the first sentence in rule 211(h)(2)-3(b) to avoid the implication that the preferential treatment granted pursuant to the disclosure exceptions in final rule 211(h)(2)-3(a) would not be captured. This change is a necessary clarification because the granting of preferential treatment with respect to redemption rights or fund portfolio holdings or exposures information would have been prohibited under proposed rule 211(h)(2)-3(a) and, accordingly, there would have

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<sup>886</sup> See ILPA Comment Letter I.

<sup>887</sup> This example assumes that the relevant excuse rights are not material economic terms required to be disclosed pre-investment by final rule 211(h)(2)(3)-(b)(1).

been nothing to disclose under proposed rule 211(h)(2)-3(b) with respect to these types of preferential treatment. Transparency into these terms will better inform investors regarding the breadth of preferential treatment, the potential for such terms to affect their investment in the private fund, and the potential costs associated with these preferential terms. Moreover, such disclosure may assist investors in determining whether the adviser offered the same redemption ability or information to all investors in the private fund, if applicable.

We are adopting the annual written notice requirement as proposed. One commenter supported the ability of an adviser to choose when to provide the annual disclosure as long as the adviser provides it on an annual basis.<sup>888</sup> Some commenters suggested that the final rule only require annual disclosure (instead of also requiring pre-investment disclosure).<sup>889</sup> We believe that the annual notice requirement will require advisers to reassess periodically the preferential terms they provide to investors in the same fund, and investors will benefit from receiving periodic updates on preferential terms provided to other investors in the same fund (*e.g.*, investors will benefit because they will be able to assess whether such preferential treatment presents new conflicts for the adviser). We also believe that providing this information annually will not overwhelm investors with disclosure.

We were not persuaded by commenters who urged us not to adopt this portion of the rule on the basis that advisers may use it to deny investors certain terms. Continuing to allow advisers to negotiate undisclosed side arrangements with certain investors that may impact other investors would be contrary to the public interest and the protection of investors because such arrangements can harm, mislead, or deceive other investors. It would also be inconsistent with

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<sup>888</sup> See AIMA/ACC Comment Letter.

<sup>889</sup> See RFG Comment Letter II; Ropes & Gray Comment Letter; PIFF Comment Letter.

promoting transparency into such arrangements. Moreover, even if advisers cease to offer certain provisions to investors, we believe the benefits associated with disclosure of preferential treatment justify such incremental burden.

Like the proposed rule, the final rule will require an adviser to describe specifically the preferential treatment to convey its relevance. One commenter argued that advisers should not be required to disclose the exact fees or other contractual terms that they negotiated and instead disclosure that some investors received preferential fees should be sufficient.<sup>890</sup> We do not believe that mere disclosure of the fact that other investors are paying lower fees is specific enough. For example, if an adviser provides an investor with lower fee terms in exchange for a significantly higher capital contribution than paid by others, an adviser must describe the lower fee terms, including the applicable rate (or range of rates if multiple investors pay such lower fees), in order to provide specific information as required by the rule. An adviser could comply with the disclosure requirements by providing copies of side letters (with identifying information regarding the other investors redacted).<sup>891</sup> 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. We believe information about fee arrangements such as those described in the example immediately above qualify as information about material economic terms that the adviser must disclose prior to the prospective investor's investment.

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<sup>890</sup> See SBAI Comment Letter.

<sup>891</sup> Advisers are not required to disclose the names or even types of investors provided preferential terms as part of this disclosure requirement. Thus, we do not believe commenters' concerns regarding investor confidentiality are supported.

## 5. Delivery

As proposed, the timing of the final rule’s delivery requirements differs depending on whether the recipient is a prospective or current investor in the private fund. For a prospective investor the notice needs to be provided, in writing, prior to the investor’s investment in the fund. For a current investor, the adviser must “distribute” the notice as soon as reasonably practicable after the end of the fund’s fundraising period (for illiquid funds) or as soon as reasonably practicable following the investor’s investment in the fund (for liquid funds).<sup>892</sup> Also, for a current investor, the adviser must distribute an annual notice if any preferential treatment is provided to an investor since the last notice.<sup>893</sup> This includes preferential information provided to any transferees during such period. If an investor is a pooled investment vehicle that is in a control relationship with the adviser, the adviser must look through that pool in order to send the notice to investors in those pools.<sup>894</sup>

We are not adopting 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). Because notices for certain funds, especially funds that provide extensive or complex preferential treatment, may take more time to prepare, a one-size-fits-all approach is not appropriate for purposes of this rule.<sup>895</sup> We believe that the “as soon as reasonably practicable”

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<sup>892</sup> Final rule 211(h)(2)-3(b)(2).

<sup>893</sup> As a practical matter, a private fund that does not admit new investors or provide new terms to existing investors does not need to deliver an annual notice. However, an adviser that enters into a side letter after the closing date of the fund must disclose any preferential terms in the side letter to investors that are locked into the fund.

<sup>894</sup> See *supra* section II.B.3 (Preparation and Distribution of Quarterly Statements).

<sup>895</sup> We recognize that the quarterly statement rule includes specified distribution timelines. The primary reason for this is to help ensure that investors can monitor their investments with regular and consistent disclosures from the adviser. Moreover, this flexible standard acknowledges that there will likely be more variance in the time required to prepare these notices as compared to the quarterly statements.

is the appropriate standard because it emphasizes the need for the notices to be distributed to investors without delay to help ensure their timeliness while affording advisers a limited degree of flexibility. 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, we believe that it would generally be appropriate for advisers to distribute the notices within four weeks.

One commenter suggested that we require advisers to provide the preferential treatment disclosures only upon request to reduce the burden on advisers and require investors to consider what information is important to them.<sup>896</sup> We believe that requiring advisers to provide and distribute the disclosures under this rule is essential to placing investors in the best position to negotiate the terms of their investment (with regard to the advance disclosure) and, with regard to the post-investment and annual disclosures, in the best position to consider and negotiate future investment opportunities, including with the adviser providing the disclosures. We are concerned that, especially with the advance disclosure requirement, requiring investors to first request information that they believe is essential to their negotiation process would serve only to disadvantage these investors both from a time and information perspective. Requiring investors to request this information could change the relationship dynamics between the adviser and investors. For example, an adviser may decide not to allow an investor with significant information requests to invest in the adviser’s future funds. Similarly, investors may hesitate to request information (even though the rules permit them to) for fear of burdening the adviser or

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<sup>896</sup> See AIMA/ACC Comment Letter.

potentially increasing the fees and expenses charged to the fund. We are not prescribing the method of delivery (*e.g.*, electronic, data room, via mail) for the written notices.<sup>897</sup>

## **6. Recordkeeping for Preferential Treatment**

We proposed amending rule 204-2 under the Advisers Act to require advisers registered with the Commission to retain books and records to support their compliance with the proposed preferential treatment rule.<sup>898</sup> Some commenters supported this amendment to the recordkeeping rule and stated that the recordkeeping obligation would ensure compliance with the rule as well as support the completeness and accuracy of records.<sup>899</sup> Another commenter stated that advisers should not be required to retain records if the prospective investor does not ultimately invest in the fund since, in that case, the prospective investor would not have received any preferential treatment.<sup>900</sup> From a practical standpoint, advisers may find it more burdensome to sort out prospective investors who did *not* ultimately invest from prospects that *did* invest in the fund. This commenter also stated that requiring an adviser to retain records from a prospective investor that does not invest in the fund could conflict with other legal obligations an adviser has (*e.g.*, data protection rules in another jurisdiction).<sup>901</sup> We recognize that advisers and their related persons may have to navigate different or potentially competing obligations under other laws, including data protection laws and marketing laws applicable in other countries; however, we do not believe that such other obligations warrant removing this requirement. Advisers will need to

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<sup>897</sup> See AIMA/ACC Comment Letter (suggesting that the final rule allow advisers to make the written notices available via a data room, where appropriate). If delivery of the required disclosure is made electronically, it should be done in accordance with the Commission's guidance regarding electronic delivery. See Use of Electronic Media Release, *supra* footnote 435; see also *supra* section II.B.3 (discussing the distribution requirements).

<sup>898</sup> Proposed rule 211(h)(2)-3(b).

<sup>899</sup> See CFA Comment Letter I; Convergence Comment Letter.

<sup>900</sup> See AIMA/ACC Comment Letter.

<sup>901</sup> See *id.*



determine whether, and how, they can engage prospective investors based on the facts and circumstances and applicable law.

Regardless of whether the investor actually receives any preferential treatment, this recordkeeping obligation is necessary to help ensure that advisers complied with the preferential treatment rule. Many advisers track which prospective investors have been contacted and what documents have been provided to them, whether through a virtual data room or otherwise. They also typically require placement agents or other third parties that are distributing fund documents on their behalf to retain an investor log, which typically includes prospective investors. Accordingly, we believe that the benefits justify the burdens associated with the rule.

We are adopting these amendments as proposed, and advisers are required to retain copies of all written notices sent to current and prospective investors in a private fund pursuant to the preferential treatment rule.<sup>902</sup> In addition, advisers are required to retain copies of a record of each addressee and the corresponding dates sent. In a change from the proposal, we are not requiring private fund advisers to make and retain records of the addresses or delivery methods used to disseminate any such written notices.<sup>903</sup> These requirements will facilitate our staff's ability to assess an adviser's compliance with the rule and will enhance an adviser's compliance efforts.

### **III. DISCUSSION OF WRITTEN DOCUMENTATION OF ALL ADVISERS' ANNUAL REVIEWS OF COMPLIANCE PROGRAMS**

We are adopting the proposed amendments to the Advisers Act compliance rule to require all SEC-registered advisers to document the annual review of their compliance policies

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<sup>902</sup> See *supra* footnote 452 (describing the record retention requirements under the books and records rule).

<sup>903</sup> See the discussion of recordkeeping requirements above in section II.B.6.

and procedures in writing, as proposed.<sup>904</sup> This requirement focuses attention on the importance of the annual compliance review process. In addition, we believe that the amendments will result in records of annual compliance reviews that allow our staff to determine whether an adviser has complied with the review requirement of the compliance rule.<sup>905</sup>

The amendment to the compliance rule requires advisers to review and document in writing, no less frequently than annually, the adequacy of their compliance policies and procedures and the effectiveness of their implementation. The annual review requirement was intended to require advisers to evaluate periodically whether their compliance policies and procedures continue to work as designed and whether changes are needed to assure their continued effectiveness.<sup>906</sup> As we stated in the Compliance Rule Adopting Release, “the annual review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies and procedures.”

Based on staff experience, we understand that some investment advisers do not make and preserve written documentation of the annual review of their compliance policies and procedures. Our examination staff relies on documentation of the annual review to help the staff understand an adviser’s compliance program, determine whether the adviser is complying with

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<sup>904</sup> Final amended rule 206(4)-7(b).

<sup>905</sup> *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [38 FR 74714 (Dec. 24, 2003)] (“Compliance Rule Adopting Release”). When adopting the compliance rule, the Commission adopted amendments to the books and records rule requiring advisers to make and keep true a copy of the adviser’s compliance policies and procedures and any records documenting an adviser’s annual review of its compliance policies and procedures. The Commission noted that this recordkeeping requirement was designed to allow our examination staff to determine whether the adviser has complied with the compliance rule. *See also* final amended rule 204-2(a)(17)(i) and (ii).

<sup>906</sup> *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2107 (Feb. 5, 2003) [68 FR 7038 (Feb. 11, 2003)].

the rule, and identify potential weaknesses in the compliance program. Without documentation that the adviser conducted the review, including information about the substance of the review, our staff has had limited visibility into the adviser’s compliance practices. The amendment to rule 206(4)-7 establishes a written documentation requirement applicable to all advisers subject to the compliance rule.<sup>907</sup>

Some commenters supported this rule,<sup>908</sup> while other commenters opposed it.<sup>909</sup> Commenters who supported the rule explained that written documentation of the annual review has been widely adopted as a standard practice by investment advisers and would not have a large impact.<sup>910</sup> The commenters that opposed it indicated that it may increase costs,<sup>911</sup> and deter an adviser from having compliance consultants or outside counsel.<sup>912</sup> A commenter that generally supported the rule cautioned that a prescriptive approach could lead to less tailored compliance reviews.<sup>913</sup>

Although we acknowledge commenters’ concerns, we continue to believe that written documentation of the annual review is necessary for three key reasons. First, written documentation of the annual review may help advisers better assess whether they have considered any compliance matters that arose during the previous year, any changes in the adviser’s or an affiliate’s business activities during the year, and any changes to the Advisers Act

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<sup>907</sup> The adviser is required to maintain the written documentation of its annual review in an easily accessible place for at least five years after the end of the fiscal year in which the review was conducted, the first two years in an appropriate office of the investment adviser. *See* rule 204-2(a)(17)(ii).

<sup>908</sup> CFA Comment Letter I; IAA Comment Letter II; Convergence Comment Letter; Comment Letter of National Regulatory Services, a ComplySci Company (Apr. 25, 2022) (“NRS Comment Letter”).

<sup>909</sup> ATR Comment Letter; NYC Bar Comment Letter II; SBAI Comment Letter.

<sup>910</sup> *See generally* SBAI Comment Letter and IAA Comment Letter II.

<sup>911</sup> NYC Bar Comment Letter II.

<sup>912</sup> Curtis Comment Letter.

<sup>913</sup> SBAI Comment Letter.

or other rules and regulations that may suggest a need to revise an adviser's policies and procedures. Second, the availability of written documentation of the annual review should allow the Commission and the Commission staff to determine if the adviser is regularly reviewing the adequacy of the adviser's policies and procedures. Third, clients and investors conducting due diligence may request written documentation of the annual review to assess whether the adviser applies a structured framework and rigor to its compliance program.

We do not believe the amended rule will significantly increase costs for advisers. Since adopting the annual review requirement,<sup>914</sup> the Commission has observed that most advisers already document this review in writing. Some advisers may see benefits in the form of increased efficiency because of the written documentation of an annual review each year. Having written documentation year over year provides the adviser a starting point so that advisers, internal service providers (*e.g.*, internal auditors), external service providers (*e.g.*, compliance consultants), or outside counsel can be more targeted when conducting future annual reviews. And, in instances where an adviser hires external service providers or outside counsel to participate in the annual review, the adviser may take steps to defray any potential costs. For example, some advisers may choose to have their employees document a summary of results as explained to them by service providers or outside counsel, rather than request that the service provider or outside counsel produce a written summary.

Nor do we believe that the amended rule will deter an adviser from using service providers (*e.g.*, compliance consultants) or outside counsel. Since early 2004, advisers have had an obligation to review, at least annually, the adequacy and effectiveness of their policies and

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<sup>914</sup> See Compliance Rule Adopting Release, *supra* footnote 905.

procedures.<sup>915</sup> Many advisers that already document the annual review in writing communicate with service providers or outside counsel, either throughout the entire annual review or for discrete issues. Nothing in this rule prohibits advisers from seeking the guidance of service providers or outside counsel during their annual review. Although this rule will now require that the adviser document the annual review in writing, it still provides advisers the flexibility to determine the scope of that review, including when, if at all, and how to communicate with service providers or outside counsel.

One commenter stated that the amendment would be unnecessarily burdensome and duplicative for asset managers that have multiple registered investment advisers operating under a common compliance program.<sup>916</sup> The commenter stated that, under the proposed amendment, advisers in an advisory complex would be producing multiple duplicative reports with little variation.<sup>917</sup> While the benefits of the produced reports may diminish with each marginal report produced with little variation, the costs will likely also decrease. We also do not believe that the marginal benefits of each report will be *de minimis*. For advisers in an advisory complex with many advisers, producing each report may help advisers assess whether they have considered any compliance matters that arose during the previous year, changes in business activities, or changes to the Advisers Act or other rules and regulations that may impact that particular adviser. Even if, in certain cases, consideration of such issues produces a similar report to a

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<sup>915</sup> *Id.*

<sup>916</sup> SIFMA-AMG Comment Letter I.

<sup>917</sup> *Id.*

previous one, there may be broader benefits across the industry from standardizing the practice of advisers making such assessments throughout their entire advisory complex.<sup>918</sup>

The amended rule does not enumerate specific elements that advisers must include in the written documentation of their annual review. The written documentation requirement is intended to be flexible to allow advisers to continue to use the review procedures they have developed and found most effective. For example, some advisers may review the adequacy of their compliance policies and procedures (or a subset of those compliance policies and procedures) and the effectiveness of their implementation on a quarterly basis. In such a case, we believe that the written documentation of the annual review could comprise written quarterly reports. Some commenters suggested that we offer flexibility in the approach to the written annual review requirement.<sup>919</sup> We have previously stated our views regarding the areas that we expect an adviser's policies and procedures to address, at a minimum, if they are relevant to the adviser.<sup>920</sup> We understand that some advisers may choose to document the annual review of their written policies and procedures: (i) in a lengthy written report with supporting documentation; (ii) quarterly documentation, aggregated at year end; (iii) a presentation to the board or another governing body, such as a limited partner advisory committee (LPAC); (iv) a short memorandum summarizing the findings; and (v) informal documentation, such a compilation of notes throughout the year.<sup>921</sup> There are a number of other ways that an adviser

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<sup>918</sup> See *infra* section VI.D.7 (Benefits and Costs – Written Documentation of All Advisers' Annual Review of Compliance Programs).

<sup>919</sup> NSCP Comment Letter; AIMA/ACC Comment Letter; SIFMA-AMG Comment Letter I.

<sup>920</sup> Compliance Rule Adopting Release, *supra* footnote 905.

<sup>921</sup> See *generally* NSCP Comment Letter.

may choose to document its annual review.<sup>922</sup> This rule does not prescribe a specific format of the written documentation, instead, allowing an adviser to determine what would be appropriate.

A commenter suggested that we should require advisers to provide the written documentation to the private fund's LPAC.<sup>923</sup> The commenter argued that this would provide evidence that the adviser has a systematic process in place to identify and address changes in the adviser's business model. While an adviser may choose to share the results of its annual review with the LPAC, or even investors in the fund, we are not requiring this. We do not believe that LPAC delivery is required to help ensure that advisers periodically evaluate whether their compliance policies and procedures continue to work as designed and whether changes are needed to assure their continued effectiveness.

The required written documentation of the annual review under the compliance rule is meant to be made available to the Commission and the Commission staff and therefore should promptly<sup>924</sup> be produced upon request.<sup>925</sup> Commission staff has observed improper claims of the attorney-client privilege, the work-product doctrine, or other similar protections over required records, including any records documenting the annual review under the compliance rule, based on reliance on attorneys working for the adviser in-house or the engagement of law firms and

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<sup>922</sup> See generally NSCP Comment Letter (describing a wide range of "other responses" for how advisers currently document their annual review in writing).

<sup>923</sup> Convergence Comment Letter.

<sup>924</sup> We have previously stated that "[w]hile the "promptly" standard [for producing books and records] imposes no specific time limit, we expect that a fund or adviser would be permitted to delay furnishing electronically stored records for more than 24 hours only in unusual circumstances. At the same time, we believe that in many cases funds and advisers could, and therefore will be required to, furnish records immediately or within a few hours of request." Electronic Recordkeeping by Investment Companies and Investment Advisers, Investment Advisers Act Rel. No. 1945 (May 24, 2001).

<sup>925</sup> In connection with the written report required under rule 38a-1, the Compliance Rule Adopting Release stated that "[a]ll reports required by our rules are meant to be made available to the Commission and the Commission staff and, thus, they are not subject to the attorney-client privilege, the work-product doctrine, or other similar protections." See Compliance Rule Adopting Release, *supra* footnote 905.

other service providers (*e.g.*, compliance consultants) through law firms.<sup>926</sup> Attempts to improperly shield from, or unnecessarily delay production of any non-privileged record is inconsistent with prompt production obligations and undermines Commission staff’s ability to conduct examinations. Prompt access to all records is critical for protecting investors and to an effective and efficient examination program.

#### **IV. TRANSITION PERIOD, COMPLIANCE DATE, LEGACY STATUS**

For the audit rule and the quarterly statement rule, we are adopting an 18-month transition period for all private fund advisers. For the adviser-led secondaries rule, the preferential treatment rule, and the restricted activities rule, we are adopting staggered compliance dates that provide for the following transition periods: for advisers with \$1.5 billion or more in private funds assets under management (“larger private fund advisers”), a 12-month transition period and for advisers with less than \$1.5 billion in private funds assets (“smaller private fund advisers”), an 18-month transition period. Compliance with the amended Advisers Act compliance rule will be required 60 days after publication in the Federal Register.

We proposed a one-year transition period to provide time for advisers to come into compliance with these new and amended rules. Some commenters suggested adopting a longer

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<sup>926</sup> Compliance Rule Adopting Release, *supra* footnote 905, at n.94. Staff also has observed delays in production of other non-privileged records. Delays undermine the staff’s ability to conduct examinations and may be inconsistent with production obligations. See OCIE National Examination Program Risk Alert: Investment Adviser Compliance Programs (Nov. 19, 2020) (“EXAMS Investment Adviser Compliance Programs Risk Alert 2020”), *available at* [https://www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs\\_0.pdf](https://www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs_0.pdf) (the staff has observed instances of advisers failing to respond in a timely manner to requests for required books and records).



transition period, such as 18 months,<sup>927</sup> two years,<sup>928</sup> or at least three years,<sup>929</sup> while other commenters have called for a swifter implementation.<sup>930</sup> Commenters also suggested an extended transition period for smaller or newer managers.<sup>931</sup> Although we considered a longer transition period for all private fund advisers, we have concerns that activity involving problematic sales practices, compensation schemes, and conflicts of interest would persist during any extended transition period to the detriment of investors.

### **Audit Rule and Quarterly Statement Rule**

We believe that the audit rule and the quarterly statement rule warrant longer transition periods because they may require advisers to enter into new, or renegotiate existing, contracts with third-party service providers, such as accountants and administrators.

First, for the mandatory audit requirement, commenters suggested that the Commission extend, for at least one additional year, the transition period to allow private funds and their auditors enough time to properly assess auditor independence requirements.<sup>932</sup> Under the mandatory private fund adviser audit rule, there will not be an option for a surprise examination as there is under the current custody rule. That is, a private fund adviser will not be able to satisfy the requirements of the audit rule by undergoing a surprise examination that would comply with the custody rule. In light of these considerations, we believe that additional time of

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<sup>927</sup> SIFMA-AMG Comment Letter I; Schulte Comment Letter; PIFF Comment Letter; CFA Comment Letter I; NSCP Comment Letter.

<sup>928</sup> MFA Comment Letter I; SBAI Comment Letter; AIC Comment Letter II.

<sup>929</sup> AIMA/ACC Comment Letter; Chamber of Commerce Comment Letter.

<sup>930</sup> Comment Letter of Los Angeles City Employees' Retirement System (Apr. 12, 2022) ("LACERS Comment Letter").

<sup>931</sup> ILPA Comment Letter I. *See also* SEC Small Business Capital Formation Advisory Committee letter to Chair Gensler (Feb. 28, 2023) (expressing concern that the proposal could adversely impact small funds that attract sophisticated investors for small companies' growth).

<sup>932</sup> E&Y Comment Letter.

up to 18 months is appropriate to allow advisers time to either hire an audit firm that meets the SEC independence requirements or cause the auditor to cease providing any services that impair independence for purposes of the SEC independence requirements.

Second, under the quarterly statement requirement, commenters expressed concern that one year may not be enough time to come into compliance with a new rule as many advisers will need to find new reporting vendors or renegotiate agreements with existing vendors to implement the required rule changes<sup>933</sup> and create and update reporting templates.<sup>934</sup> Commenters also highlighted that advisers may need additional time to make the necessary adjustments to their operational and compliance systems.<sup>935</sup> Based on these comments, we have also decided to allow up to 18 months to comply with the quarterly statement requirement. We believe this transition period will provide an appropriate period of time that balances the needs of advisers to engage third parties and amend existing forms, with the needs of investors to receive this information.

#### **Adviser-Led Secondaries, Preferential Treatment, and Restricted Activities Rules**

Commenters requested an extended transition period for smaller or newer managers, stating that smaller or newer managers may require more time to modify practices to come into compliance.<sup>936</sup> We agree with these commenters that smaller private fund advisers will likely need additional time to modify existing practices, policies, and procedures to come into compliance. Accordingly, we are providing staggered compliance dates, with a longer transition

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<sup>933</sup> Curtis Comment Letter; NRS Comment Letter; *see generally* NSCP Comment Letter.

<sup>934</sup> SBAI Comment Letter; REBNY Comment Letter; *see generally* AIC Comment Letter I.

<sup>935</sup> AIC Comment Letter I; *see also* Chamber of Commerce Comment Letter (advisers may need to build and implement compliance structures and systems to address new elements of the rules).

<sup>936</sup> ILPA Comment Letter I; CVCA Comment Letter.

period for smaller private fund advisers. The compliance date for larger private fund advisers will provide for a 12-month transition period, while the compliance date for smaller private fund advisers will provide for an 18-month transition period. This additional time will allow smaller private fund advisers, and their service providers, to adequately address the various new requirements under the rules and promote a smooth and efficient implementation of the rules. We believe that, by allowing a longer transition period for smaller advisers, the costs of compliance would be lessened by the sharing of industry knowledge from larger advisers that were required to comply at least six months earlier. For example, smaller advisers would be afforded more time to assess which parts of the implementation process can be performed in house versus those that must be outsourced and to identify, and negotiate with, appropriate service providers. Smaller private fund advisers will also likely receive the benefit of model forms and templates developed by larger private fund advisers and their service providers, which may reduce costs for smaller private fund advisers.

We are differentiating between larger private fund advisers and smaller private fund advisers based on private fund assets under management, calculated as of the last day of the adviser's most recently completed fiscal year. An adviser's private fund assets under management are the portion of such adviser's regulatory assets under management that are attributable to private funds it advises.<sup>937</sup> We chose to use the term "private fund assets under management" because many advisers are familiar with such term under Form PF. Investment advisers registered (or required to be registered) with the Commission with at least \$150 million in private fund assets under management generally must file Form PF.<sup>938</sup> Accordingly, we

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<sup>937</sup> Regulatory assets under management are calculated in accordance with Part 1A, Instruction 5.b of Form ADV.

<sup>938</sup> See 17 CFR 275.204(b)-1.

believe that private fund assets under management is appropriate to use here because many advisers will already be familiar with how to calculate their private fund assets under management.

One commenter suggested differentiating between advisers based on specific parameters (*e.g.*, assets under management).<sup>939</sup> Another commenter suggested using a combination of specific metrics, such as employee headcount and assets under management, to determine if a firm meets the threshold for being a larger private fund adviser.<sup>940</sup> We considered using metrics other than, or in addition to, private fund assets under management for purposes of this threshold, but we anticipate that they would be more likely to lead to adverse incentives or otherwise be less reliable metrics. For instance, if we were to define larger private fund advisers based on number of employees, advisers may be incentivized to outsource operations and minimize compliance personnel. Also, unlike private fund assets under management, employee headcount attributable to an adviser's private funds is generally not tracked or reported to the Commission.<sup>941</sup> We believe that private fund assets under management is the appropriate metric because it is less likely to create adverse incentives and is more likely to be tracked and reported by private fund advisers than other metrics.

We believe that \$1.5 billion in private fund assets under management is the appropriate threshold for a tiered compliance date for smaller private fund advisers.<sup>942</sup> The threshold is

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<sup>939</sup> ILPA Comment Letter I.

<sup>940</sup> Predistribution Initiative Comment Letter II.

<sup>941</sup> We note that Form ADV, Part 1, Item 5 requires an adviser to disclose certain information regarding its employees, including the number of full- and part-time employees,

<sup>942</sup> Form PF also uses a \$1.5 billion threshold. Specifically, a private fund adviser must complete section 2 of Form PF if it had at least \$1.5 billion in hedge fund assets under management as of the last day of any month in the fiscal quarter immediately preceding the adviser's most recently completed fiscal quarter. Section 2a requires a large hedge fund adviser to report certain aggregate information about any hedge fund

designed so that the group of larger private fund advisers will be relatively small in number but represent a substantial portion of the assets of the private funds industry. For example, we estimate that approximately 1,478 SEC registered investment advisers each managing at least \$1.5 billion in private fund assets represent approximately 75% of private fund assets under management advised by registered private fund advisers and exempt reporting advisers.<sup>943</sup> Similarly, we estimate that approximately 491 exempt reporting advisers each managing at least \$1.5 billion in private fund assets represent approximately 16% of private fund assets under management advised by exempt reporting advisers and registered private fund advisers.<sup>944</sup> We considered selecting a different threshold, such as \$2 billion in private fund assets under management. However, we believe that \$1.5 billion is appropriate because, as discussed above, it captures a relatively small number of advisers but represents a substantial portion of the assets under management advised by registered private fund advisers and exempt reporting advisers. We do not believe a \$2 billion threshold would capture a significant enough portion of the assets in the private fund adviser industry.

We also chose the \$1.5 billion threshold because we believe advisers with \$1.5 billion or more in private fund assets generally have larger back offices to assist with the adoption and implementation of the new rules. Larger advisers are more likely to have launched more than one private fund and thus may have more experience in complying with Commission rules and

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it advises and section 2b requires a large hedge fund adviser to report certain additional information about any hedge fund it advises that has a net asset value of at least \$500 million as of the last day of any month in the fiscal quarter immediately preceding the adviser's most recently completed fiscal quarter.

<sup>943</sup> See Form ADV data (as of Dec. 2022). This \$1.5 billion in private fund assets threshold does not include SAF advisers with respect to SAFs they advise.

<sup>944</sup> *Id.* Aggregate totals may include duplicative data to the extent a private fund is reported on Form ADV by both a registered investment adviser and an exempt reporting adviser (*e.g.*, in the case of a sub-advisory or co-advisory relationship).

potentially have been registered with us for a longer period of time. Accordingly, we believe that the \$1.5 billion threshold strikes an appropriate balance between ensuring that a significant portion of private fund advisers implements the various rules reasonably quickly, while seeking to minimize the initial burdens imposed on certain private fund advisers.

### **Amended Advisers Act Compliance Rule**

The written documentation of an adviser's annual review impacts all advisers, whether they advise private funds or not. This requirement to document in writing, at least annually, the adviser's annual review of the adequacy and effectiveness of its policies and procedures is an important part of an effective compliance program. Because of this importance, we have decided to require compliance with this rule 60 days after publication in the Federal Register. We also believe that documenting an existing practice in writing does not warrant a longer transition period because the additional burden should be relatively low for two important reasons. First, most advisers are already documenting their annual review in writing, so these advisers would have to make limited, if any, changes to existing practices.<sup>945</sup> Second, we did not prescribe a specific format for the written documentation, allowing advisers flexibility to record the results of the annual review in a manner that best fits their business and to use the review procedures

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<sup>945</sup> See SBAI Comment Letter (the written annual review “is already common practice in the industry and would not have a large impact”); *see also* IAA Comment Letter II (“a written annual review has been a widely adopted best practice for investment advisers, including private fund advisers, for years”); *see also* NRS Comment Letter (“most SEC registered investment advisers regularly document their annual reviews, though the format, scope, and detail provided in this documentation varies widely from firm to firm”); *see generally* NSCP Comment Letter (noting that, in a survey of members, 213 out of 214 members responded that they already document the annual review in writing).

that they have found most effective.<sup>946</sup> Thus, whenever the adviser commences its review within the next 12 months after the compliance date, the review must be documented in writing.<sup>947</sup>

In summary, the following tables set forth the compliance dates:

<b>Rule</b>	<b>Larger Private Fund Advisers</b>	<b>Smaller Private Fund Advisers</b>
211(h)(1)-2	18 months after date of publication in the Federal Register	18 months after date of publication in the Federal Register
206(4)-10	18 months after date of publication in the Federal Register	18 months after date of publication in the Federal Register
211(h)(2)-1	12 months after date of publication in the Federal Register	18 months after date of publication in the Federal Register
211(h)(2)-2	12 months after date of publication in the Federal Register	18 months after date of publication in the Federal Register
211(h)(2)-3	12 months after date of publication in the Federal Register	18 months after date of publication in the Federal Register

<b>Rule</b>	<b>All Investment Advisers</b>
206(4)-7(b)	60 days after publication in the Federal Register

### **Legacy Status**

Commenters requested the Commission not to apply the final rules to existing funds and their contractual agreements (*i.e.*, provide “legacy status” for such funds and agreements).

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<sup>946</sup> See *supra* section III.

<sup>947</sup> For an adviser that completed its annual review immediately before the Commission voted to adopt this rule, this could mean that the adviser documents the annual review, in writing, for the first time up to 14 months after the Commission’s vote, which should allow an adviser more than enough time to determine how to document the annual review. To the extent an adviser has a review year that is partially complete by the compliance date and the adviser has already reviewed the adequacy of its policies and procedures in accordance with rule 206(4)-7 for such period prior to the compliance date, the new documentation requirement will not apply retroactively to such period.

Several commenters suggested providing legacy status for all existing funds,<sup>948</sup> while some commenters recommended legacy status for all funds currently in compliance<sup>949</sup> and other commenters recommended permitting legacy status for 10 years.<sup>950</sup>

After considering these comments, we are providing legacy status under the prohibitions aspect of the preferential treatment rule, which prohibits advisers from providing certain preferential redemption rights and information about portfolio holdings. We are also providing legacy status for the aspects of the restricted activities rule that require investor consent, which restrict an adviser from borrowing from a private fund and from charging for certain investigation fees and expenses. However, such legacy status does not permit advisers to charge for fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Act or the rules promulgated thereunder.<sup>951</sup>

The legacy status provisions apply to governing agreements, as specified below, that were entered into prior to the compliance date if the rule would require the parties to amend such an agreement.<sup>952</sup> To prevent advisers from abusing this provision, legacy status applies only to

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<sup>948</sup> See, e.g., SIFMA-AMG Comment Letter I; NSCP Comment Letter; Chamber of Commerce Comment Letter; Segal Marco Comment Letter; Schulte Comment Letter; BVCA Comment Letter; Invest Europe Comment Letter; PIFF Comment Letter; MFA Comment Letter I; AIMA/ACC Comment Letter; SBAI Comment Letter; GPEVCA Comment Letter; Top Tier Comment Letter; George T. Lee Comment Letter; CCMR Comment Letter I; Andreessen Comment Letter; Ropes & Gray Comment Letter; NYC Bar Comment Letter II; Pathway Comment Letter; Cartwright et al. Comment Letter; Canada Pension Comment Letter.

<sup>949</sup> See, e.g., Comment Letter of Michelle Katauskas (Apr. 19, 2022); CVCA Comment Letter.

<sup>950</sup> See, e.g., Cartwright et al. Comment Letter.

<sup>951</sup> See final rule 211(h)(2)-1(b). For the avoidance of doubt, and for the reasons specified in section II.E.2.a) above, we have specified that the legacy status provision does not permit advisers to charge for 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 Act or the rules promulgated thereunder.

<sup>952</sup> See final rules 211(h)(2)-1(b) and 211(h)(2)-3(a).



such agreements with respect to private funds that had commenced operations as of the compliance date. The commencement of operations includes any *bona fide* activity directed towards operating a private fund, including investment, fundraising, or operational activity. Examples of activity that could indicate a private fund has commenced operations include issuing capital calls, setting up a subscription facility for the fund, holding an initial fund closing and conducting due diligence on potential fund investments, or making an investment on behalf of the fund.

Some commenters suggested that we also apply legacy status to the disclosure portions of the preferential treatment rule so that the rule would only apply to new agreements (*e.g.*, side letters) entered into after the effective/compliance date.<sup>953</sup> These commenters noted that side letters are negotiated on a confidential basis and requiring disclosure of such bespoke terms would violate existing agreements.<sup>954</sup> Also, they argued that applying the rule to existing side letters would result in repapering costs to advisers and investors.<sup>955</sup> We are not applying legacy status to the disclosure portions of the preferential treatment rule because we believe that transparency of these terms is important and will not harm investors in the private fund. As a result, information in side letters that existed before the compliance date will be disclosed to other investors that invest in the fund post compliance date. Advisers are not required to disclose the identity of the specific investor that received a preferential term and can choose to anonymize that information. Commenters also opposed any application of the rule that would require retroactive changes to existing side letters, and we believe requiring the disclosure of side letters

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<sup>953</sup> See, *e.g.*, SBAI Comment Letter; Comment Letter of CompliDynamics APC (Apr. 24, 2022); Dechert Comment Letter; NYC Comptroller Comment Letter; Ropes & Gray Comment Letter.

<sup>954</sup> See, *e.g.*, SBAI Comment Letter; Dechert Comment Letter (stating that “[t]hese arrangements were reached with the general expectation of confidentiality”).

<sup>955</sup> See, *e.g.*, NYC Comptroller Comment Letter; SBAI Comment Letter.

that were entered into before the compliance date, rather than the outright prohibition of preferential terms under existing side letters, is the best path forward to avoid the costs associated with rewriting and renegotiating existing agreements.<sup>956</sup> Similarly, we are not applying legacy status to the aspects of the restricted activities rule with disclosure-based exceptions because transparency into these practices is important and will not harm investors in the private fund.

This legacy treatment is designed to address commenters' concerns that the rules would require advisers and investors to renegotiate contractual agreements at a significant cost to the industry,<sup>957</sup> including for investors that may not have internal counsel to renegotiate contracts with advisers. Moreover, requiring advisers and investors to modify fund terms or alter their rights in order to comply with the rules would likely require the private funds industry to devote substantial time to such process (rather than focusing on the investment process) and yield unintended consequences for the industry.

The legacy provisions apply with respect to contractual agreements that (i) govern the fund, which include, but are not limited to, the private fund's operating or organizational agreements (*e.g.*, the limited partnership agreement, the limited liability company agreement, articles of association, or by-laws), the subscription agreements, and side letters and (ii) govern the borrowing, loan, or extension of credit entered into by the fund, which include, but are not limited to, the foregoing agreements from clause (i), if applicable, as well as promissory notes and credit agreements. As discussed above, amendments to governing documents warrant legacy treatment because of how disruptive and costly that process can be. We view the following as

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<sup>956</sup> See, *e.g.*, Canada Pension Comment Letter; Pathway Comment Letter.

<sup>957</sup> MFA Comment Letter I; PIFF Comment Letter; AIMA/ACC Comment Letter; SIFMA-AMG Comment Letter I.

examples of amendments to such governing agreements: (i) changing or removing redemption terms for one or more investors where such terms are specified in the governing agreement; and (ii) removing terms from a side letter that granted an investor redemption rights or periodic reporting about the fund's holdings or exposures.<sup>958</sup> In contrast, disclosure of information (*e.g.*, under the disclosure portion of the preferential treatment rule and the restricted activities rule) is not as burdensome or disruptive and therefore does not warrant legacy treatment.

The legacy provisions apply only with respect to advisers' existing agreements with parties as of the compliance date.<sup>959</sup> As a result, an adviser may not add parties to the side letter after the compliance date in order to do indirectly what it is prohibited from doing directly.<sup>960</sup> However, we would not view an adviser to a fund who admits new investors to an existing fund as violating the legacy provisions to the extent the applicable terms are set forth in the fund's limited partnership (or similar) agreement and applicable to all investors.

We are not providing legacy status under the other final rules because we do not believe that the requirements of those rules will typically require advisers and investors to amend binding contractual agreements. Also, the quarterly statement rule, the audit rule, the disclosure aspects of the restricted activities rule, and the adviser-led secondaries rule do not flatly prohibit activities, except for the charging of fees and expenses related to sanctions for violations of the

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<sup>958</sup> We would also interpret the legacy status provision for the borrowing restriction to apply to existing borrowings from a private fund that has commenced operations as of the compliance date and that were entered into in writing prior to the compliance date. Thus, an adviser would not be required to seek consent for such existing borrowings for purposes of the final rule.

<sup>959</sup> We anticipate that the applicable parties to fund governing documents generally would be the general partner/adviser and investors; however, we used a broader term because some investors may authorize other persons to sign documents on their behalf, such as nominees. Similarly, in the context of certain non-U.S. funds, the parties to the governing agreements may be a board of directors or certain other persons, acting on the fund's or the adviser's behalf.

<sup>960</sup> See section 208(d) of the Advisers Act.

Act. Rather, these rules generally require advisers to provide certain information to or obtain consent from investors.

## **V. OTHER MATTERS**

Pursuant to the Congressional Review Act,<sup>961</sup> the Office of Information and Regulatory Affairs has designated this rule a “major rule” as defined by 5 U.S.C. 804(2). If any of the provisions of these rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

## **VI. ECONOMIC ANALYSIS**

### **A. Introduction**

We are mindful of the costs imposed by, and the benefits obtained from, the final rules. Whenever we engage in rulemaking and are required to consider or determine whether an action is necessary or appropriate in the public interest, section 202(c) of the Advisers Act requires the Commission to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation. The following analysis considers, in detail, the potential economic effects that may result from these final rules, including the benefits and costs to market participants as well as the implications of the final rules for efficiency, competition, and capital formation.

Where possible, the Commission quantifies the likely economic effects of its final amendments and rules. However, the Commission is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges of costs. Further, in some cases, quantification would require numerous assumptions to forecast how investment

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<sup>961</sup> 5 U.S.C. 801 *et seq.*

advisers and other affected parties would respond to the amendments and rules, and how those responses would in turn affect the broader markets in which they operate. In addition, many factors determining the economic effects of the amendments and rules would be firm-specific and thus inherently difficult to quantify, such that, even if it were possible to calculate a range of potential quantitative estimates, that range would be so wide as to not be informative about the magnitude of the benefits or costs associated with the rules and amendments. Many parts of the discussion below are, therefore, qualitative in nature. As described more fully below, the Commission is providing a qualitative assessment and, where feasible, a quantified estimate of the economic effects.

## **B. Broad Economic Considerations**

As discussed above, private fund assets under management have steadily increased over the past decade.<sup>962</sup> Additionally, private funds and their advisers play an increasingly important role in the lives of millions of Americans planning for retirement.<sup>963</sup> While private funds typically issue their securities only to certain qualified investors, such as institutions and high net worth individuals, individuals have indirect exposure to private funds through those individuals' participation in public and private pension plans, endowments, foundations, and certain other retirement plans, which all invest directly in private funds.<sup>964</sup>

Many commenters argued in response to the Proposing Release that the private fund industry is competitive and not in need of further regulation, and that private incentives and

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<sup>962</sup> See *supra* section I; see also *infra* section VI.C.1.

<sup>963</sup> *Id.*

<sup>964</sup> *Id.*

negotiations already yield competitive outcomes.<sup>965</sup> Other commenters stated that the Proposing Release did not demonstrate or provide evidence of a market failure to provide a rationale for the proposed rules, or did not provide sufficient quantifiable justification of the benefits of the rule relative to the costs.<sup>966</sup> These comments also generally stated that financial regulation in the absence of such market failures results in negative unintended consequences, such as reduced capital formation, higher prices, or lower overall economic activity.<sup>967</sup> Commenters stated that new regulations, if any, should prioritize or be limited to ensuring full and fair disclosure.<sup>968</sup>

One commenter representing a fund adviser group stated that the development of the potentially harmful practices at issue in the proposal is evidence of market efficiency, as it shows the development of differentiated investor terms that are responsive to unique investor needs.<sup>969</sup>

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<sup>965</sup> See, e.g., MFA Comment Letter I, Appendix A (“The Commission fails to consider that sophisticated investors invest in private funds and does not establish that sophisticated investors need the purported protections outlined in the Proposal.”); AIC Comment Letter I, Appendix 1 (“Private equity is a competitive industry with thousands of advisory firms on one side and sophisticated investors on the other side. Certain characteristics of the private equity industry, which the Commission is concerned about, emerge as a result of negotiations between sophisticated parties, and the literature provides economic reasons for these patterns in the data.”); AIC Comment Letter I, Appendix 2 (“If investment advisers all have market power and private funds are in short supply, LPs will have little bargaining power if they wish to be included in a particular fund. By contrast, if the IAs compete to attract investable resources, the supply of private funds should be substantial and LPs should be able to negotiate contractual terms that reflect their preferences and trade-offs. In particular, if the SEC has identified practices that are generally viewed negatively by LPs, an adviser that tried to impose these practices will find it more difficult to attract investments than one who offers some flexibility. There are many IAs offering private funds but, unfortunately, the Proposal and economic analysis provide no evidence about their market power. Yet this assessment should have a first-order impact on appropriate regulatory changes.”); Comment Letter of Professor William Clayton (Apr. 21, 2022) (“Clayton Comment Letter I”) (“The Proposal also includes various explanations for why bargaining in private funds might be leading to unsatisfying outcomes. Interestingly, these claims are not presented as part of a clear and unified thesis for why suboptimal bargaining happens in this industry. Instead, the staff’s discussion of bargaining problems is scattered throughout the Proposal, and one might miss the descriptions of these bargaining problems if one is not looking carefully for them.”).

<sup>966</sup> See, e.g., ATR Comment Letter; Comment Letter of Harvey Pitt (Apr. 18, 2022) (“Harvey Pitt Comment Letter”); SBAI Comment Letter; LSTA Comment Letter, Exhibit C; Cartwright et al. Comment Letter.

<sup>967</sup> See, e.g., AIC Comment Letter I, Appendix 1; Segal Marco Comment Letter; SBAI Comment Letter.

<sup>968</sup> See, e.g., Clayton Comment Letter I; MFA Comment Letter I; Dechert Comment Letter.

<sup>969</sup> AIMA/ACC Comment Letter.

Commenters representing advisers also stated that the growth of private funds provides evidence that the market is not in need of further regulation,<sup>970</sup> and that the number of private fund advisers and low concentration of assets under management indicate the private equity market is competitive.<sup>971</sup> One investor comment letter also stated that private markets have “thrived,” stating that investors are well-compensated for the risks they face.<sup>972</sup>

We view these commenters’ statements as contributing to three principal arguments that will be analyzed in this section.<sup>973</sup> First, commenters’ statements contribute to an argument that the size and sophistication of private fund investors indicates they are able to negotiate with their advisers for themselves.<sup>974</sup> Second, commenters’ statements contribute to an argument that if any potential private fund investor were arguably unable to sufficiently negotiate for its interests in a private fund, the investor could instead invest in publicly-traded securities along with a range of other available investment options.<sup>975</sup> This would indicate that private fund investors allocating to private fund investments must have sufficient information to be responsibly making their current allocations.<sup>976</sup> Third, as a closely related matter, commenters’ statements contribute

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<sup>970</sup> See, e.g., AIMA/ACC Comment Letter; AIC Comment Letter I, Appendix 1; MFA Comment Letter I, Appendix A.

<sup>971</sup> Comment Letter of Committee on Capital Market Regulation (May 25, 2023) (“CCMR Comment Letter IV”); CCMR, A COMPETITIVE ANALYSIS OF THE U.S. PRIVATE EQUITY FUND MARKET (Apr. 2023), available at <https://capmktreg.org/wp-content/uploads/2023/04/CCMR-Private-Equity-Funds-Competition-Analysis-04.11.20231.pdf>.

<sup>972</sup> OPERS Comment Letter.

<sup>973</sup> We discuss other commenter concerns, such as commenter concerns on specific economic aspects of individual rules, throughout the remainder of section VI.

<sup>974</sup> See, e.g., Harvey Pitt Comment Letter; AIC Comment Letter I, Appendix 2; OPERS Comment Letter.

<sup>975</sup> See, e.g., AIC Comment Letter I; AIC Comment Letter I, Appendix 1; MFA Comment Letter I; CCMR Comment Letter IV.

<sup>976</sup> *Id.*

to an argument that new regulations, if any, should prioritize enhancing disclosures to help ensure private fund investors have sufficient information.<sup>977</sup>

Separately, one commenter stated that the proposal failed to meet the Office of Management and Budget’s guidelines for performing a regulatory impact analysis as set out under certain executive orders and laws.<sup>978</sup> The Commission was not required to perform a regulatory impact analysis but complied with the Regulatory Flexibility Act and the Paperwork Reduction Act and included a robust economic analysis in the Proposing Release.<sup>979</sup>

Conversely, several investor commenters provided insight into the specific private fund market structures and resulting market failures that motivate regulation of private fund advisers and inform the specific types of regulations that would be appropriate. Specifically, investor commentary suggests that investors face difficulties in negotiating reforms because of the bargaining power held by fund advisers and because of the bargaining power held by larger investors who are able to secure preferential terms that carry a risk of having a material, negative effect on other investors.

Analysis of industry comments demonstrates that fund advisers have multiple sources of bargaining power, which we discuss in turn, and we also discuss the bargaining power held by

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<sup>977</sup> See, e.g., Clayton Comment Letter I; MFA Comment Letter I; Dechert Comment Letter.

<sup>978</sup> See LSTA Comment Letter, Exhibit C.

<sup>979</sup> The Commission is subject to the Paperwork Reduction Act of 1995 (“PRA”), the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”), and the Regulatory Flexibility Act (“RFA”). See also Staff’s “Current Guidance on Economic Analysis in SEC Rulemaking” (March 16, 2012), available at [https://www.sec.gov/divisions/riskfin/rsfi\\_guidance\\_econ\\_analy\\_secrulemaking.pdf](https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf) (“Staff’s Current Guidance on Economic Analysis in SEC Rulemaking”). The commenter also referred to the Unfunded Mandate Reform Act of 1995, but that Act does not apply to rules issued by independent regulatory agencies. See 2 USC §1501 et seq, stating “The term ‘agency’ has the same meaning as defined in section 551(1) of title 5, United States Code, but does not include independent regulatory agencies.” See also CONG. RESEARCH SERV., UNFUNDED MANDATES REFORM ACT: HISTORY, IMPACT, AND ISSUES (July 17, 2020), available at <https://crsreports.congress.gov/product/pdf/R/R40957/108> (noting “[UMRA] does not apply to duties stemming from participation in voluntary federal programs [or] rules issued by independent regulatory agencies”). See also *infra* section VIII.



certain investors that may harm other investors with less bargaining power.<sup>980</sup> We specifically have analyzed all three categories of the broad arguments above. That is, we have analyzed below market failures that can prevent private fund investors from efficiently negotiating for themselves with private fund advisers. Second, we have analyzed below market failures that can prevent private fund investors from being able to exit their private fund adviser negotiations, including market failures that prevent private fund investors from exiting private fund allocations entirely in favor of publicly traded securities or other investment options. Third, we have analyzed the extent to which market failures could have been addressed by disclosure and, in some cases, consent requirements alone. To the extent that these market failures negatively affect the efficiency with which investors search for and match with advisers, the alignment of investor and adviser interests, investor confidence in private fund markets, or competition between advisers, then the final rules may improve efficiency, competition, and capital formation in addition to benefiting investors.<sup>981</sup> For example, an academic study found that the passing of regulation requiring advisers to hedge funds to register with the SEC reduced misreporting of results to hedge fund investors, misreporting increased on the overturn of that legislation, and that the passing of the Dodd-Frank Act (which reinstated certain regulations for hedge funds) resulted in higher inflows of capital to hedge funds, indicating that hedge fund investors view regulatory oversight as protecting their interests.<sup>982</sup>

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<sup>980</sup> The Proposing Release also considered whether conflicts of interest associated with specific contractual terms themselves constituted a market failure preventing private reform. Proposing Release, *supra* footnote 3, at 214-215. However, commenters argued that conflicts of interest arising from specific contractual terms after the investor enters into a relationship cannot constitute a market failure, and the analysis must instead consider why investors accept contractual terms associated with conflicts of interest in the first place. See, e.g., Clayton Comment Letter I.

<sup>981</sup> See *infra* section VI.E. See also, e.g., Consumer Federation of America Comment Letter.

<sup>982</sup> Stephen G. Dimmock & William Christopher Gerken, *Regulatory Oversight and Return Misreporting by Hedge Funds*, 20 REV. FIN., EURO. FIN. ASSOC. 795-821 (2016), available at <https://ssrn.com/abstract=2260058>.

This analysis yields six key conclusions. First, investors and advisers may have asymmetric abilities to gather information, as fund advisers often have greater information as to their negotiation options available to them than do many investors. Second, it may be difficult solely as a matter of coordination for private fund advisers to adopt a common, standardized set of detailed disclosures and possibly further consent requirements that achieve sufficient transparency. The remaining sources of asymmetric bargaining power between investors and advisers and among investors necessitate reforms beyond disclosures and consent requirements. Third, investors have worse outside options to a given negotiation than the adviser, including cases where investors are limited in their ability to exit a negotiation with a private fund adviser in favor of turning to public markets or other investment options. Fourth, these descriptions of bargaining difficulties for investors are consistent with a view that smaller investors who lack bargaining power also face a collective action problem. Fifth, even if investors could coordinate, there is substantial variation across investors in terms of their ability to bargain with private fund advisers, and larger investors with more bargaining power may benefit from using their bargaining power to extract terms that may risk materially, negatively affecting other investors. Lastly, there may be additional internal principal-agent problems at private fund investors, between investment committees and their own beneficiaries, in which investment committees have limited incentives to intensely negotiate for reforms that are in the interests of their beneficiaries. We discuss each of these issues in turn in the remainder of this section.

First, investors and advisers may have asymmetric abilities to gather information, as fund advisers often have greater information as to their negotiation options available to them than do

many investors.<sup>983</sup> We understand many investors lack the resources to negotiate and conduct due diligence with a large number of fund advisers simultaneously. As one commenter states, each investor negotiates the private fund terms on a separate basis with the fund adviser.<sup>984</sup> This problem is exacerbated by the fact that many investors’ internal diversification requirements and objectives and underwriting standards generally leave them with a smaller pool of advisers with whom they can negotiate.<sup>985</sup> One commenter and industry report further stated that “[c]onversations with industry parties (including several advisers and consultants) and directly with [investors] suggest that there may only be a ‘handful’ or ‘a dozen’ eligible funds for a given investment” when taking into account the investor’s limitations on the size of the investor’s potential investments, and diversification across vintage years, size, sector, strategy, and

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<sup>983</sup> Comment Letter of Prof. William Clayton (Dec. 22, 2022) (“Clayton Comment Letter II”) (citing “Insufficient information on ‘what’s market’ in fund terms” as a reason LPs are accepting poor legal terms in LPAs). This evidence has been corroborated in industry literature and by another commenter. See Comment Letter of Institutional Limited Partners Association (Mar. 9, 2023) (“ILPA Comment Letter II”); ILPA, THE FUTURE OF PRIVATE EQUITY REGULATION, INSIGHT INTO THE LIMITED PARTNER EXPERIENCE & THE SEC’S PROPOSED PRIVATE FUND ADVISERS RULE (2023), *available at* <https://ilpa.org/wp-content/uploads/2023/03/ILPA-SEC-Private-Fund-Advisers-Analysis.pdf>; ILPA, PRIVATE FUND ADVISERS DATA PACKET, COMPANION DATA PACKET TO THE FUTURE OF PRIVATE EQUITY REGULATION ANALYSIS (2023), *available at* <https://ilpa.org/wp-content/uploads/2023/03/ILPA-Private-Fund-Advisers-Data-Packet-March-2023-Final.pdf>; William W. Clayton, *High-End Bargaining Problems*, 75 VAND. L. REV. 703 (2022), *available at* <https://vanderbiltlawreview.org/lawreview/wp-content/uploads/sites/278/2022/04/1-Clayton-Paginated-v3.pdf>; Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCs AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (Robert W. Hillman and Mark J. Loewenstein eds., 2015) (“Based on the cases we have decided and our reading of many other cases decided by our judicial colleagues, we do not discern evidence of arms-length bargaining between sponsors and investors in the governing instruments of alternative entities. Furthermore, it seems that when investors try to evaluate contract terms, the expansive contractual freedom authorized by the alternative entity statutes hampers rather than helps. A lack of standardization prevails in the alternative entity arena, imposing material transaction costs on investors with corresponding effects for the cost of capital borne by sponsors, without generating offsetting benefits. Because contractual drafting is a difficult task, it is also not clear that even alternative entity managers are always well served by situational deviations from predictable defaults.”).

<sup>984</sup> See NY State Comptroller Comment Letter.

<sup>985</sup> *Id.*; see also, e.g., *Pension Funds, What is a Pension Fund?*, CFA INSTITUTE (2023), *available at* <https://www.cfainstitute.org/en/advocacy/issues/pension-funds#sort=%40pubbrowsedate%20descending>.

geography.<sup>986</sup> Having a smaller pool of advisers with whom investors can negotiate reduces their access to information on what terms are consistent with the market.

Meanwhile, and by contrast, many fund advisers can negotiate with comparatively more investors simultaneously. In particular, although advisers face restrictions around their ability to admit certain investors such as benefit plans subject to ERISA,<sup>987</sup> advisers are typically less restricted in their ability to market to and accept investments from a wide variety of investors as compared to investor ability to negotiate and invest with a wide variety of advisers. This increases the adviser's information as to what terms may be accepted by different investors.

The ILPA comment letter and industry report also states that many investor negotiations are with advisers that are represented by the same law firms. As a result, advisers represented by those law firms gain bargaining power from being able to gather information about negotiations between other investors and other advisers represented by the same law firm.<sup>988</sup> For example, in private equity, the leading five global law firms represented advisers to private funds that raised over \$380 billion in capital from October 2021 to September 2022 from global investors, and the leading 10 represented advisers who raised almost \$500 billion in capital.<sup>989</sup> A single law firm represented advisers to private funds that accounted for \$171 billion of that capital.<sup>990</sup> In the first

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<sup>986</sup> ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983, at 30. While commenters also discussed limitations based on institutional track records, we do not consider those to be as relevant of restrictions contributing to market failures, because competitive forces operating correctly will also result in advisers with stronger institutional track record having greater bargaining power.

<sup>987</sup> For example, an employee benefit plan or pension plan subject to ERISA may be required to redeem its interest under certain circumstances to prevent the fund's assets from becoming plan assets of the investor, and such requirements for those investors may limit an adviser's ability to admit those plans as an investor. *See, e.g.*, NEBF Comment Letter.

<sup>988</sup> ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983, at 4.

<sup>989</sup> Carmela Mendoza, *PEI Fund Formation League Table Reveals Industry's Top Law Firms*, Priv. Equity Int'l (Feb. 15, 2023), *available at* <https://www.privateequityinternational.com/pei-fund-formation-league-table-reveals-industrys-top-law-firms/>.

<sup>990</sup> *Id.*

half of 2022, total capital raised by private equity funds globally accounted for \$337 billion.<sup>991</sup>

Comparing this to the amounts raised by private funds represented by leading law firms indicates the leading 10 law firms represented funds that likely accounted for approximately 75% of global private equity capital raised in 2022, and one law firm alone represented funds that likely accounted for approximately 25% of global private equity capital raised in 2022.<sup>992</sup>

However, investor consultants can also provide services such as negotiating for fee reductions, providing analytics on a specific fund or investor portfolio performance, or valuation reporting, among others.<sup>993</sup> These investor consultants may partially or fully offset the information asymmetry and resulting bargaining power that advisers receive from industry consolidation of law firms. We have considered that the ILPA comment letter and report does not discuss how enhanced information for advisers from adviser law firm concentration may be mitigated by investors relying on investment consultants, who provide advice to investors with large amounts of assets and may provide preliminary screens of advisers or databases of information on advisers.<sup>994</sup> For example, in principle and given sufficient bargaining power by investor consultants, investor consultant screens of advisers could filter advisers based on offerings of investor-friendly contractual terms and quickly provide investors with complete

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<sup>991</sup> Carmela Mendoza, *Fundraising Sees \$122 Billion Drop in the First Half of 2022*, Priv. Equity Int'l (July 28, 2022), available at <https://www.privateequityinternational.com/fundraising-sees-122bn-drop-in-the-first-half-of-2022>.

<sup>992</sup> *Id.* These figures are global, and so comparable figures for the U.S. market that will be subject to the final rules may differ from those presented here. We are not aware of data on comparable figures for the U.S. market that will be subject to the final rules. However, North American private equity funds accounted for more than 40% of all private equity capital raised in the first half of 2022, which limits how much the law firm concentration of private fund capital raises may differ for U.S. markets in comparison to global markets. *Id.*

<sup>993</sup> See, e.g., *Services*, ALBOURNE, available at <https://www-us.albourne.com/albourne/services>.

<sup>994</sup> See, e.g., *Asset Managers' Latest Big Investment: Consultant Relations*, CHIEF INVESTMENT OFFICER (July 8, 2016), available at <https://www.ai-cio.com/news/asset-managers-latest-big-investment-consultant-relations/>.

information as to the landscape of those investor-friendly contractual terms, thereby inducing advisers to offer more investor-friendly terms over time.

However, there are two reasons we believe the involvement of investor consultants may not sufficiently offset all information asymmetries and resulting bargaining asymmetries. First, one survey result indicates that these consultants may not entirely offset all such information asymmetries, as the survey reports that 73% of private equity investor respondents disagree or strongly disagree with the statement that the private equity industry is unconcentrated, such that investors have flexibility to switch advisers.<sup>995</sup> Almost all respondents reported that the starting point of contractual LPA terms and the final negotiated LPA terms have become more adviser-friendly over the last three years.<sup>996</sup> Because at least one commenter has stated that such survey results may not be reliable, based on a statement that investors bargaining with advisers may rationally seek the assistance of outside parties such as industry researchers to alter negotiation outcomes even absent any market failure,<sup>997</sup> we have further considered non-survey evidence. Second, while there is not comprehensive data comparing industry concentration of investor consultants to industry concentration of adviser law firms, one industry report shows that the investor consultant industry may be substantially less concentrated than the adviser law firm industry, as the report shows 231 public pension plans reported commitments of \$190.8 billion to

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<sup>995</sup> ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983. If the industry were unconcentrated and investors were free to flexibly switch advisers, economic theory would predict that competition between advisers would absolve asymmetries of bargaining power, as advisers would have to offer investors more attractive terms, such as more transparency and disclosure rights, in order to secure investor business.

<sup>996</sup> ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983.

<sup>997</sup> *See, e.g.*, Harvey Pitt Comment Letter.

private funds in 2021, and the top five consultants advised \$23.5 billion.<sup>998</sup> Similarly, for private equity in 2022, a report shows 155 public pension plans reported commitments of \$88.4 billion to private equity funds, the top consultant advised \$7.2 billion (8.2%), top five consultants advised \$18.2 billion (20.6%) and the top 10 consultants advised \$21.7 billion (24.5%).<sup>999</sup> While these data points may have some differences in focus from the industry report on adviser law firm concentration above (for example, this concentration measure pertains to the United States, while the report above considers global concentration), the concentration measures of the two industries in these reports differ so substantially that we believe they are informative of potential overall differences in market power between adviser law firms and investor consultants.

The second factor that may give advisers bargaining power is that it may be difficult solely as a matter of coordination for private fund advisers to adopt a common, standardized set of detailed disclosures and consent practices that achieve sufficient transparency, because investors and advisers compete and negotiate independently of each other on many dimensions, including performance statistics, management fees, fund expenses, performance-based compensation, and more.<sup>1000</sup> For example, recent industry literature has documented ongoing

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<sup>998</sup> Andrés Ramos, Content Marketing Specialist, Nasdaq Private Fund Solutions, *Understanding the Consultant Landscape in the Private Markets*, available at <https://privatemarkets.evestment.com/blog/understanding-the-consultant-landscape-in-the-private-markets/>; NASDAQ, PRIVATE FUND TRENDS REPORT 2021-2022, available at <https://www.nasdaq.com/solutions/asset-owners/insights/private-fund-trends>.

<sup>999</sup> Private Fund Trends Report 2022-2023, *supra* footnote 998.

<sup>1000</sup> Academic literature discussed in the comment file debates whether privately organized standardized disclosures are more or less efficient than regulated or mandated disclosures. *See, e.g.*, Memo Re: Aug. 18, 2022, Meeting with Prof. William Clayton; *see also, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984). Certain investors and industry groups have encouraged advisers to adopt uniform reporting templates to promote transparency and alignment of interests between advisers and investors. *See, e.g.*, *Reporting Template*, ILPA, available at <https://ilpa.org/reporting-template/>. Despite these efforts, many advisers still do not provide adequate disclosure to investors. In 2021, 59% of LPs in a survey reported receiving the template more than half the time, indicating that LPs must continue to use their negotiating resources to receive the template. *See infra* section VI.C.3; *see also* ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983, at 17; ILPA Private Fund Advisers Data Packet, *supra* footnote 983.

challenges in achieving standardization of disclosures around the impact of subscription lines of credit on performance.<sup>1001</sup>

While asymmetric information and difficulties in coordinating standardized disclosures and consent practices provide an economic rationale for new regulations for practices of private fund advisers to the extent that those issues result in investor harm or negatively affect efficiency, competition, or capital formation, they do not offer a complete picture as to the necessary degree of regulation. As one commenter states, many imbalances in bargaining power can be resolved through enhanced disclosure alone, and do not necessitate either prohibiting any activities or making any non-disclosure activities mandatory.<sup>1002</sup> We agree that policy decisions can benefit from taking into account the causes of bargaining failures or other market frictions.<sup>1003</sup>

While this commenter did not discuss consent requirements,<sup>1004</sup> commenters generally contemplated consent requirements as potential policy choices for certain aspects of the final rules.<sup>1005</sup> We have therefore also considered consent requirements, in addition to disclosure requirements, as potential policy solutions to the bargaining imbalances described in this release.<sup>1006</sup> In particular, consent requirements may be effective policy solutions in cases where investors and advisers have asymmetric information, but the nature and degree of asymmetric

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<sup>1001</sup> See *infra* section VI.C.3; see also ILPA, ENHANCING TRANSPARENCY AROUND SUBSCRIPTION LINES OF CREDIT, RECOMMENDED DISCLOSURES REGARDING EXPOSURE, CAPITAL CALLS AND PERFORMANCE IMPACTS (June 2020), available at [https://ilpa.org/wp-content/uploads/2020/06/ILPA-Guidance-on-Disclosures-Related-to-Subscription-Lines-of-Credit\\_2020\\_FINAL.pdf](https://ilpa.org/wp-content/uploads/2020/06/ILPA-Guidance-on-Disclosures-Related-to-Subscription-Lines-of-Credit_2020_FINAL.pdf).

<sup>1002</sup> Clayton Comment Letter II.

<sup>1003</sup> *Id.*

<sup>1004</sup> *Id.*

<sup>1005</sup> See, e.g., BVCA Comment Letter; MFA Comment Letter I; AIMA/ACC Comment Letter.

<sup>1006</sup> See *infra* sections VI.D, VI.F.



information is uncertain or may change over time, such that disclosure requirements may be difficult to tailor in a way that resolves the asymmetry of information on their own without further consent practices. For example, commenters stated that several of the proposed prohibited activities, such as advisers borrowing from their funds, may be beneficial to the fund and its investors,<sup>1007</sup> while the Proposing Release contemplated ways in which these activities may harm the fund and its investors.<sup>1008</sup> Whether the activity benefits the fund and its investors, or the adviser at the expense of the fund and its investors, can depend on the terms and price of the advisers' activity, the reasons for the adviser undertaking the activity, or both. In these cases, it may be difficult for investors, with disclosure alone, to analyze the implications of the advisers' activity, and it may be difficult for disclosure requirements alone to capture the asymmetric information possessed by the adviser that would benefit the investor. We believe these cases motivate consent requirements in addition to disclosure requirements in certain cases.

We believe that many of the bargaining imbalances described in the Proposing Release and in this release may be improved through enhanced disclosure and, in some cases, consent requirements, and have tailored many of the final rules accordingly. This includes revising several proposed rules that would have prohibited certain activities outright to instead provide for certain exceptions in the final rules where the adviser makes an appropriate enhanced disclosure and, in some cases, obtains investor consent. We believe these revisions substantially preserve economic benefits, including positive effects on the process by which investors search for and match with advisers, the alignment of investor and adviser interests, investor confidence in private fund markets, and competition between advisers. Because consent requirements for

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<sup>1007</sup> See, e.g., SBAI Comment Letter; CFA Comment Letter I; AIC Comment Letter I.

<sup>1008</sup> Proposing Release, *supra* footnote 3, at 232.

certain restricted activities also directly enhance the bargaining power of investors, by providing investors an opportunity to offer consent only upon receiving certain concessions, the inclusion of certain consent requirements also enhances investor ability to secure additional information from advisers. These positive effects may improve efficiency, competition, and capital formation in addition to benefiting investors,<sup>1009</sup> while reducing the risks of the negative unintended consequences identified by commenters.<sup>1010</sup>

However, we believe that certain targeted further reforms, namely the prohibition of certain preferential terms that the adviser reasonably expects would have a material, negative effect on other investors and the mandatory audits, are necessitated by several additional sources of asymmetric bargaining power between investors and advisers and among investors. We believe those imbalances are not fully resolved by enhanced disclosure and would also not be fully resolved by requiring investor consent, and that those imbalances may further negatively affect the efficiency with which investors search for and match with advisers, the alignment of investor and adviser interests, investor confidence in private fund markets, and competition between advisers.

As a third source of bargaining power imbalances between investors and advisers, investors have worse outside options to a given negotiation than the adviser. As discussed above, many investors face complex internal administrative and regulatory requirements that govern their negotiations with advisers.<sup>1011</sup> This means that investors in private funds often face high upfront costs of identifying advisers who meet their administrative and regulatory

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<sup>1009</sup> See *infra* section VI.E.

<sup>1010</sup> See, e.g., AIC Comment Letter I, Appendix 1.

<sup>1011</sup> See *supra* footnote 983-986 and accompanying text.

requirements, with due diligence costs such as fees for investment consultants.<sup>1012</sup> The result is that, once a relationship with such an adviser is established, the cost of leaving that adviser to search for another adviser can be high, because many of these upfront costs of administrative and regulatory due diligence must be repeated. Investors may also have predetermined investment allocations to private funds, as stated by one commenter.<sup>1013</sup> For an investment committee of an investor with a predetermined investment allocation to private funds, they may have no outside option to a given negotiation at all, as they are required to allocate a set amount of funds to a private investment. Advisers may also benefit in the negotiation from knowing that an investment committee with a predetermined investment allocation to private funds must select an adviser within a certain time frame, and therefore may have limited ability to walk away from the negotiation and find a new adviser. This is consistent with one recent survey of attorneys representing private equity investors, in which over 40% of respondents reported that the investors were “unable” or unwilling to walk away from bad terms.<sup>1014</sup>

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<sup>1012</sup> See *supra* footnote 993 and accompanying text.

<sup>1013</sup> See, e.g., *CalPERS Investment Fund Values*, CALPERS (Nov. 18, 2022), available at <https://www.calpers.ca.gov/page/investments/about-investment-office/investment-organization/investment-fund-values> (showing \$48.8 billion or 11.5% asset allocation towards private equity); OKLAHOMA MUNICIPAL RETIREMENT FUND, AUDIT REPORTS (2022), available at <https://www.okmrf.org/financial/#investments> (showing an allocation of approximately \$50 million out of total investments of \$600 million allocated to hedge fund investments); Healthy Markets Comment Letter I (“Many institutional private fund investors, such as public pension funds, have predetermined investment allocations to alternative investment strategies. As allocations to private fund investments have generally risen in recent years, investors have faced increased competition to participate in investment vehicles offered by leading advisers or specific attractive opportunities. In fact, as this competition for the opportunity to invest has increased, many institutional investors have been compelled to lower their demands upon private fund advisers, including accepting even egregious, anti-investor contractual provisions, such as purported waivers of liability.”).

<sup>1014</sup> Clayton Comment Letter II.

As a related matter, even outside these predetermined allocations, many public pension plans have turned to private funds in an attempt to address underfunding problems.<sup>1015</sup> The academic and industry literature has documented that U.S. public pension plans face a stark funding gap, in which states on average had less than 70% of the assets needed to fund their pension liabilities, with that figure for some states reaching as low as 34%.<sup>1016</sup> This further limits the ability of public pension plans, an important category of private fund investor, to exit a private fund negotiation and, for example, invest in public markets instead.

These issues indicate that many investors therefore have strong incentives to compromise to pursue repeat business with the same fund adviser,<sup>1017</sup> and that many investors negotiating with fund advisers simply do not have the outside option of turning to public markets. In the survey described above,<sup>1018</sup> nearly 60% of respondents reported “fear of losing allocation” as an explanation for why investors have accepted poor legal terms in LPAs.<sup>1019</sup> These asymmetries in bargaining power may be exacerbated for smaller investors: Nearly 50% of respondents reported

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<sup>1015</sup> This is driven in part by private markets outperforming public benchmarks. Some commenters discussed the relative performance of private markets and public benchmarks. *See, e.g.*, CCMR Comment Letter IV.

<sup>1016</sup> *See, e.g.*, Professor Clayton Public Investors Article, *supra* footnote 12; Sarah Krouse, *The Pension Hole for U.S. Cities and States Is the Size of Germany’s Economy*, WALL ST. J. (July 30, 2018), *available at* <https://www.wsj.com/articles/the-pension-hole-for-u-s-cities-and-states-is-the-size-of-japans-economy-1532972501> (retrieved from Factiva database); PEW CHARITABLE TRUSTS, THE STATE PENSION FUNDING GAP: 2017, ISSUE BRIEF (June 27, 2019), *available at* <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/06/the-state-pension-funding-gap-2017>.

<sup>1017</sup> The asymmetries of information also contribute to investors having poor outside options to their negotiations: Because investors have less information as to what terms are market than do their private fund advisers, they face a more uncertain outcome as to what terms they might receive with their next adviser if they leave their current adviser. For risk-averse investors, this uncertainty incentivizes investors to accept terms in their current negotiation that they otherwise might not. *See, e.g.*, Clayton Comment Letter II; ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983; ILPA Private Fund Advisers Data Packet, *supra* footnote 983.

<sup>1018</sup> Clayton Comment Letter II. This evidence has been corroborated in industry literature and by another commenter. *See* ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983; ILPA Private Fund Advisers Data Packet, *supra* footnote 983.

<sup>1019</sup> *Id.*

having too small of a commitment size as an explanation for why investors have accepted poor legal terms.<sup>1020</sup>

Investors may have fewer outside options as to who their next negotiating partner will be if they leave their current private fund or other funds with the same adviser, for example because of the consolidation of law firms representing advisers.<sup>1021</sup> As a result, investors considering leaving a negotiation have a high probability of having to pay high fixed costs to find a new negotiating partner, only to end up negotiating with the same law firm again. As noted above, while many advisers benefit from the reliability and security of repeat investors, and face certain regulatory burdens such as restrictions around ERISA funds they are typically otherwise less restricted in their ability to market to and accept investments from a wide variety of investors.<sup>1022</sup> We believe these imbalances in bargaining power may be a factor in the cases of disadvantaged investors accepting fund terms in which the fund will not be audited or in which other investors will receive preferential treatment that may have a material, negative effect on other investors in the fund, and these imbalances are not resolved by disclosure.

Fourth, these descriptions of bargaining difficulties for investors are consistent with a view that smaller investors who lack bargaining power also face a collective action problem. Investors are unable to negotiate with each other because advisers often impose non-disclosure agreements or other confidentiality provisions that restrict each investor from being able to learn from the adviser who the other investors are, and as a result investors are hindered from collectively negotiating. To the extent that advisers have differential pricing power over

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<sup>1020</sup> *Id.*

<sup>1021</sup> One commenter also stated that law firms that serve as external counsel to private equity managers have incentives to push back on investor-friendly terms. *See* Clayton Comment Letter II.

<sup>1022</sup> *See supra* footnote 987 and accompanying text.

different kinds of investors, they are incentivized to offer terms to some investors that extract surplus from investors with the least bargaining power and transfer it to the investors with the most bargaining power. The non-disclosure agreements and other confidentiality restrictions currently benefit larger investors who have sufficient bargaining power to negotiate unilaterally but may prevent smaller investors from engaging in collective action.

Specifically, contract terms that offer preferential treatment to advantaged investors may impose a negative externality on disadvantaged investors. If the disadvantaged investors could collectively bargain with the advantaged investors and the adviser, all parties could potentially agree to terms in which the disadvantaged investors would pay greater fees, the advantaged investors would pay reduced fees (or even received some fixed payout), and the preferential terms would be removed from the contract. As one commenter states, “[p]rivately negotiating various side letters[,] however[,] has instead pitted LPs against one another rather than collectively trying to negotiate for a standard set of disclosures and investment terms from the GPs.”<sup>1023</sup>

For example, when advisers offer preferential redemption terms to only certain advantaged investors that materially negatively affect other investors, those advantaged investors experience a reduction in the risk of their payouts from the private fund, and the disadvantaged investors who do not receive preferential redemption terms face an increase in the risk of their payouts from the private fund. Depending on the relative risk preferences of the two sets of investors, there may exist some payout from the disadvantaged investors to the advantaged investors in exchange for the removal of the preferential redemption terms that could leave all

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<sup>1023</sup> Comment Letter of Americans for Financial Reform Education Fund, et al. (May 8, 2023) (“AFREF Comment Letter IV”).

parties better off. Because contracts are individually negotiated between single investors and the adviser and because advisers are typically not permitted to reveal identities of other investors, which prevents investors from communicating with each other, there is no scope for a private resolution to this collective action problem.

Fifth, even if investors could coordinate, there is substantial variation across investors in the private fund space in terms of their ability to bargain, and larger investors with more bargaining power may benefit from using their bargaining power to extract terms that may risk materially, negatively affecting other investors. Not all private fund investors are large negotiators with the resources to bargain effectively, and the largest investors who negotiate the most intensely may not want to coordinate or collectively negotiate with smaller advisers or may benefit from negotiating separately from smaller advisers.

Specifically, as we discuss in detail further below, the ability for certain preferred investors with sufficient bargaining power to secure preferential terms that would have a material, negative effect on other investors leaves the preferred investors in a scenario where they can opportunistically “hold-up” other investors, exploiting their preferred terms.<sup>1024</sup> As a specific example of how this might occur, an adviser with repeat business from a large investor with early redemption rights and smaller investors with no early redemption rights may have adverse incentives to take on extra risk, as the adviser’s preferred investor could exercise its early redemption rights to avoid the bulk of losses in the event an investment begins to fail. The result is that the larger investors, who can secure preferential redemption terms, benefit from having smaller investors in their funds who must negotiate independently and do not have the

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<sup>1024</sup> See *infra* section VI.D.4.

same bargaining resources as the larger investors.<sup>1025</sup> This is because preferential redemption rights gain value from the presence of other investors who can be “held up,” with investors sharing returns equally when investments succeed but disproportionately allocating losses to the smaller investors when an investment begins to fail.

Those private fund investors who are smaller than the largest investors, and therefore may be less able to bargain than the largest investors, may not be able to appreciate, even with disclosure, and also may not be able to appreciate after providing investor consent, the full ramifications of these bargaining outcomes or the contractual terms that they agree to in the case of preferential treatment that the adviser reasonably expects to have a material, negative effect on the investors who do not receive it. As stated above, in one recent survey of private equity investors, nearly 50% of respondents reported that they accept poor legal terms because the commitment size of their institution is too small,<sup>1026</sup> indicating potential unlevel playing fields for smaller investors who are the most likely to be the investors lacking bargaining power. One commenter stated that smaller investors receive less timely and complete information than other investors, indicating only certain investors receive preferential information.<sup>1027</sup> That commenter also stated that preferential fund terms primarily benefit larger, more advantaged investors.<sup>1028</sup>

This asymmetry in bargaining power across investors, and the lack of incentive to coordinate across investors with different levels of bargaining power, provides a specific economic rationale for the prohibition of certain preferential terms that would have a material, negative effect on other investors. Several commenters’ letters supported this economic

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<sup>1025</sup> Similar outcomes can arise in the case of preferential information. *See infra* section VI.D.4.

<sup>1026</sup> Clayton Comment Letter II.

<sup>1027</sup> Healthy Markets Comment Letter I.

<sup>1028</sup> *Id.*



rationale, commenting on these types of asymmetries across investors for all categories of private funds.<sup>1029</sup> Because the preferential terms that are prohibited in the final rule are only those that the adviser reasonably expects to have a material, negative effect on other investors, we believe the rule is focused on the case where an investor's ability to extract such terms is itself evidence of substantial bargaining power on the part of the investor. This economic rationale is bolstered by the variation in commenter response to the proposal to prohibit certain preferential terms, with certain investors themselves opposing the prohibition and others supporting it.<sup>1030</sup>

These specific problems may be difficult, or unable, to be addressed via enhanced disclosures and consent requirements alone. For example, investors facing a collective action problem today, in which they are unable to coordinate their negotiations, would still be unable to coordinate their negotiations even if consent was sought from each investor for a particular adviser practice. As another example, in cases where certain preferred investors with sufficient bargaining power secure preferential terms over disadvantaged investors, majority consent by investor interest requirements may have minimal ability to protect the disadvantaged investors, as we would expect the larger, preferred investors to outvote the disadvantaged investors.

While there are cases where the prohibited preferential treatment terms can result in investor harm outside the context of redemptions, and we discuss all such cases below,<sup>1031</sup> the leading cases are focused on redemption rights, which may on average be more relevant for hedge funds and other liquid funds than for illiquid funds or other funds that offer more limited

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<sup>1029</sup> See, e.g., AFREF Comment Letter IV; LACERS Comment Letter; NEBF Comment Letter; OFT Comment Letter.

<sup>1030</sup> See, e.g., Carta Comment Letter; Meketa Comment Letter; Lockstep Ventures Comment Letter; LACERS Comment Letter; AFREF Comment Letter IV; NY State Comptroller Comment Letter; Weiss Comment Letter; AIC Comment Letter I, Appendix 2; MFA Comment Letter II.

<sup>1031</sup> See *infra* section VI.D.4.

redemption or withdrawal rights. Therefore, with respect to the final rules prohibiting certain preferential treatment, we again believe the policy decision has benefited from taking into account the causes of bargaining failures or other market frictions.<sup>1032</sup>

As a final matter, one commenter points to additional internal principal-agent problems at private fund investors, between investment committees and their own beneficiaries, in which investment committees have limited incentives to intensely negotiate for reforms that are in the interests of their beneficiaries, but not necessarily further the interests of the investment committee.<sup>1033</sup> Conversely, investment committees may have incentives to maintain existing structures that are to their benefit, but are not in the interest of fund beneficiaries.<sup>1034</sup> For example, academic literature has theorized that staff members of institutional investors may have incentives to structure contracts in opaque ways to advance their own career interests, that staff at institutional investors may have incentives to demand overstated reported returns from fund advisers, or that institutional investor committees may have incentives to overinvest in private equity funds making investments in their local markets.<sup>1035</sup> Other literature has analyzed public pension plan investments in private funds more broadly and raised concerns as to whether public pension plan trustees and officials adequately protect the interests of their beneficiaries when negotiating.<sup>1036</sup>

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<sup>1032</sup> See *supra* section VI.B.

<sup>1033</sup> See Clayton Comment Letter II; see also, e.g., Yael V. Hochberg & Joshua D. Rauh, *Local Overweighting and Underperformance: Evidence from Limited Partner Private Equity Investments*, 26 REV. FIN. STDS. 403 (2013); Blake Jackson, David C. Ling & Andy Naranjo, *Catering and Return Manipulation in Private Equity* (Oct. 11, 2022), available at <https://ssrn.com/abstract=4244467> (retrieved from SSRN Elsevier database).

<sup>1034</sup> *Id.*

<sup>1035</sup> *Id.*

<sup>1036</sup> Clayton Comment Letter II; see also, e.g., Professor Clayton Public Investors Article, *supra* footnote 12.

In light of these enhanced considerations from the comment file, we can more closely evaluate statements by commenters presenting arguments that no further regulation is needed. In particular, and as briefly noted above, one commenter and industry report stated that, because the private equity industry has a large number of advisers and funds with low concentrations of assets under management and capital raised, the industry must already be competitive.<sup>1037</sup> While that commenter and report did not discuss hedge funds, that commenter and report stated that, for example, the capital raised by new funds established by the five largest PE fund advisers has not exceeded 15% of total capital raised by new PE funds from 2013-2021.<sup>1038</sup> The commenter and report conclude that, because the private equity industry is already highly competitive, further regulation would reduce competition in that market.<sup>1039</sup>

However, we believe this analysis may not fully take into account the imbalances and inefficiencies in the bargaining process discussed above. For example, this analysis does not take into account investor limitations on size of the investors' potential investments institutional track record, and diversification across vintage years, size, sector, strategy, and geography, and therefore overstates the number of advisers and funds available to any given investor.<sup>1040</sup> As another example, even though adviser law firm concentration may be offset by investor consultant concentration, an analysis of private equity industry concentration solely by counts of the number of private equity funds and advisers, and the distribution by assets under

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<sup>1037</sup> CCMR Comment Letter IV; A Competitive Analysis of the U.S. Private Equity Fund Market, *supra* footnote 971. This commenter's analysis is limited to the private equity market. Other commenters also stated that there are a large number of private fund advisers in the industry more generally, without analyzing the concentration of capital raised or assets under management. *See supra* footnote 970 and accompanying text; *see also, e.g.*, AIMA/ACC Comment Letter; AIC Comment Letter I, Appendix 1; MFA Comment Letter I, Appendix A.

<sup>1038</sup> *Id.*

<sup>1039</sup> *Id.*

<sup>1040</sup> *See supra* footnote 986.

management, fails to take into account the effects of either adviser law firms or investor consultants.<sup>1041</sup> As a third example, the analysis does not take into consideration the fact that investors can have predetermined investment allocations to private funds that must be satisfied within a certain time frame, limiting their ability to freely exit negotiations.<sup>1042</sup> While these efficiencies and imbalances may be mitigated by having a marketplace with a large number of advisers, it may be difficult for competitive forces solely driven by low industry concentration to fully resolve these issues with the bargaining process itself.

The commenter and report also argue that the presence of price competition in the market for private equity is evidence that the market is competitive and not in need of further regulation.<sup>1043</sup> However, the analysis considers only price competition and ignores competition over non-price contractual terms. An analysis of price competition overlooks the staff observations on harmful practices and non-price contractual terms contemplated in the Proposing Release and in this release, such as private fund advisers offering preferential redemption terms to only certain investors. Competition between advisers over whether they offer preferential redemption terms, or other non-price contractual terms, cannot be reliably measured in an analysis solely focused on price competition across advisers. As another commenter notes, academic literature has documented that among private fund advisers, there is substantial negotiation over non-price contractual terms.<sup>1044</sup> In particular, in a recent industry survey of ILPA members, almost all respondents reported that the starting point of contractual LPA terms

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<sup>1041</sup> See *supra* footnotes 988 and accompanying text.

<sup>1042</sup> See *supra* footnotes 1013-1014 and accompanying text.

<sup>1043</sup> CCMR Comment Letter IV; A Competitive Analysis of the U.S. Private Equity Fund Market, *supra* footnote 971.

<sup>1044</sup> Clayton Comment Letter II; PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE, at 31-32, 45-47 (The MIT Press, 2002).

and the final negotiated LPA terms have become more adviser-friendly over the last three years.<sup>1045</sup> As a final matter, price competition may vary in its intensity between different types of private funds in a way not accounted for by the CCMR comment letter and report. In a recent study on the performance of hedge fund fees, the authors find that hedge fund compensation structures have resulted in investors collecting only 36% of the returns earned on their invested capital (over the risk-free rate).<sup>1046</sup>

For these reasons, we believe certain particularly harmful practices can warrant stricter regulation, such as mandating protective actions like audits or prohibiting particularly problematic or harmful practices.<sup>1047</sup> For smaller investors with less bargaining power who may be more vulnerable, advisers may have conflicts of interest between the fund's interests and their own interests (or "conflicting arrangements"). These conflicts reduce advisers' incentives to act in the best interests of the fund. For example, an adviser attempting to raise capital for a successor fund has an incentive to inflate valuations and performance measurements of the current fund.

Many commenters argued that private fund investors are sophisticated negotiators, and that the Commission should not insert itself into commercial negotiations between sophisticated

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<sup>1045</sup> The Future of Private Equity Regulation, *supra* footnote 983; ILPA Private Fund Advisers Data Packet, *supra* footnote 983.

<sup>1046</sup> Itzhak Ben-David, Justin Birru & Andrea Rossi, *The Performance of Hedge Fund Performance Fees*, Fisher College of Bus. Working Paper No. 2020-03-014, Charles A. Dice Working Paper No. 2020-14, (June 24, 2020), *available at* <https://ssrn.com/abstract=3630723> (retrieved from SSRN Elsevier database).

<sup>1047</sup> That is, these additional bargaining power asymmetries are unlikely to be resolved by disclosure alone. Moreover, because the preferential treatment rule specifically considers the case where the adviser benefits larger investors at the expense of smaller investors, and because smaller investors generally have more limited ability to identify outside options to their current adviser, these market failures also are unlikely to be resolved by consent requirements. *See infra* section VI.D.4.

parties.<sup>1048</sup> Other commenters highlighted specific proposed prohibited activities such as the prohibition on reducing adviser clawbacks for taxes paid and the prohibition on borrowing, and stated that the prohibited activities represent outcomes of sophisticated negotiations.<sup>1049</sup> Commenters also cited the overall burden of the rule, and expressed concern that the rule would negatively impact private fund competition and capital formation.<sup>1050</sup> Some of these commenters specifically expressed a concern that the impact on competition would occur because the compliance costs of the rule would cause smaller advisers to exit.<sup>1051</sup>

While we acknowledge commenters' concerns, we remain convinced by the evidence of market failures in the private fund adviser industry. We believe, as discussed further below, that these commenters fail to acknowledge that (i) the substantial growth of private funds has included interest and participation by smaller investors who may lack bargaining resources, and be more vulnerable than the largest investors,<sup>1052</sup> and (ii) many attorneys representing investors report in survey evidence that investors accept poor legal terms in negotiations because the commitment size of their institution is too small, or they have a fear of losing their allocation, or

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<sup>1048</sup> See, e.g., PIFF Comment Letter; IAA Comment Letter; AIMA/ACC Comment Letter; BVCA Comment Letter; Comment Letter of Bill Huizenga and French Hill (Apr. 25, 2022); MFA Comment Letter I; Grundfest Comment Letter.

<sup>1049</sup> See, e.g., Grundfest Comment Letter; AIC Comment Letter I; Ropes & Gray Comment Letter; SBAI Comment Letter; AIMA/ACC Comment Letter.

<sup>1050</sup> See, e.g., Carta Comment Letter; Meketa Comment Letter; Lockstep Ventures Comment Letter; NY State Comptroller Comment Letter; AIC Comment Letter I, Appendix 1; AIC Comment Letter I, Appendix 2; MFA Comment Letter I, Appendix A.

<sup>1051</sup> See, e.g., AIC Comment Letter I, Appendix 1; AIC Comment Letter I, Appendix 2; MFA Comment Letter I, Appendix A; NAIC Comment Letter. These commenters also expressed concerns that the loss of smaller advisers would result in reduced diversity of investment advisers, based on an assertion that most women- and minority-owned advisers are smaller and are smaller and associated with first time funds. To the extent compliance costs cause smaller advisers to exit, reduced diversity of investment advisers may be a negative effect of the rule. We discuss these effects further in section VI.E.2.

<sup>1052</sup> See *infra* section VI.C.1.

they are unable or unwilling to walk away from bad terms.<sup>1053</sup> Some commenters stated that the proposed prohibitions on certain preferential treatment would cause advisers to be less inclined to accept smaller investors,<sup>1054</sup> and while we agree that this could occur and some investors may face additional difficulties securing an investment in a private fund, we also believe this observation concedes the existence of smaller investors, who are more likely to lack bargaining resources.<sup>1055</sup> Another commenter, even though they did not describe specific structural elements of the private fund marketplace that result in market failures, broadly supported the view that the bargaining process in private fund negotiations is not even and requires further regulation.<sup>1056</sup>

We have revised the final rules accordingly to take into consideration the specific causes of bargaining failure. In doing so, we also believe we have not overly prescribed market practices. We also believe we have addressed commenters' concerns that overly prescriptive market practices should not be imposed based solely on self-reported survey evidence from investors, who may be incentivized to seek the assistance of industry researchers or the Commission to improve their negotiation outcomes, even absent any market failure.<sup>1057</sup> We have addressed this issue both by revising the final rules relative to the proposal, such as by revising the restricted activities rule to provide for certain exceptions where required disclosures

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<sup>1053</sup> Clayton Comment Letter II; ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983; ILPA Private Fund Advisers Data Packet, *supra* footnote 983.

<sup>1054</sup> See, e.g., Ropes & Gray Comment Letter.

<sup>1055</sup> See *infra* sections VI.C.1, VI.D.4.

<sup>1056</sup> ICCR Comment Letter.

<sup>1057</sup> See, e.g., Harvey Pitt Comment Letter.

are made and, in some cases, where investor consent is obtained, and by considering a wider variety of evidence than self-reported survey evidence from investors.<sup>1058</sup>

In particular, we disagree with commenters who believe the Commission conceptualizes all investors as alike, or who interpret the Commission's goal as creating a one-size-fits-all solution for all private fund advisers.<sup>1059</sup> The variation in responses to surveys of investor groups,<sup>1060</sup> the variation identified by commenters in reporting preferences of investors,<sup>1061</sup> the variation identified by commenters in the degree to which different investors receive preferential treatment,<sup>1062</sup> the variation identified by commenters in terms of the different types of structures of private funds and how those structures meet investor needs,<sup>1063</sup> and all other instances of variation across fund outcomes are all substantial evidence of the variation in private fund investors. Moreover, the economic rationale for the prohibition on certain preferential terms that the adviser reasonably expects would have a material, negative effect on other investors relies substantially on a view that certain investors are larger, with more bargaining resources, and able to secure terms that leave them in an advantaged position relative to other investors. As stated above, this economic rationale is bolstered by the variation in commenter response to the

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<sup>1058</sup> See, e.g., *supra* footnotes 989, 1013, 1046 and accompanying text.

<sup>1059</sup> See, e.g., AIC Comment Letter I, Appendix 2; Schulte Comment Letter; PIFF Comment Letter.

<sup>1060</sup> Clayton Comment Letter II; ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983; ILPA Private Fund Advisers Data Packet, *supra* footnote 983.

<sup>1061</sup> See, e.g., PIFF Comment Letter; NYC Comptroller Letter.

<sup>1062</sup> See, e.g., Carta Comment Letter; Meketa Comment Letter; Lockstep Ventures Comment Letter; NY State Comptroller Comment Letter; Weiss Comment Letter; AIC Comment Letter I; AIC Comment Letter I, Appendix 2; MFA Comment Letter II.

<sup>1063</sup> See, e.g., LSTA Comment Letter.



proposal to prohibit certain preferential terms, with certain investors themselves opposing the prohibition and others supporting it.<sup>1064</sup>

We also believe we have preserved the ability for advisers and investors to flexibly negotiate fund terms, including via certain changes that are in response to commenters. For example, advisers and investors may still negotiate to identify any performance metrics that they believe will be beneficial to investors, so long as the minimum requirements of the quarterly statement rule are met.<sup>1065</sup> Advisers and investors may also still negotiate for preferential terms for certain investors, as long as those terms are properly disclosed and are not redemption rights or information that would likely have a material negative effect on other investors.<sup>1066</sup> Different investors with different risk preferences or different needs may also accept different redemption rights or information rights, as long as those rights and information are offered to all existing and future investors.<sup>1067</sup> Investors and advisers may further negotiate whether the adviser will engage in the restricted activities under the rule, subject to certain disclosure and, in some cases, consent requirements.<sup>1068</sup> Investor and adviser negotiation over the restricted activities may still include negotiations over which party will bear certain categories of risks based on investor and adviser risk preference, including compliance risks of the fund or adviser facing regulatory expenses, such as investigation expenses.<sup>1069</sup> Lastly, we have respected the different types of private fund structures and the needs of their investors, for example by not applying the private

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<sup>1064</sup> See *supra* footnote 1050 and accompanying text; see also, e.g., Carta Comment Letter; Meketa Comment Letter; Lockstep Ventures Comment Letter; NY State Comptroller Comment Letter; Weiss Comment Letter; AIC Comment Letter I; AIC Comment Letter I, Appendix 2; MFA Comment Letter II.

<sup>1065</sup> See, e.g., PIFF Comment Letter; NYC Comptroller Letter; see also *supra* section II.B.

<sup>1066</sup> See *supra* section II.F.

<sup>1067</sup> See *infra* section VI.D.4.

<sup>1068</sup> See *supra* section II.E.

<sup>1069</sup> *Id.*, see also *infra* section VI.D.3.

fund rules to advisers with respect to SAFs they advise,<sup>1070</sup> and with a provision of the mandatory audit rule that an adviser is only required to take all reasonable steps to cause its private fund client to undergo an audit that satisfies the rule when the adviser does not control the private fund and is neither controlled by nor under common control with the fund.<sup>1071</sup> We therefore believe the final rules mitigate burden where possible and continue to facilitate competition and facilitate flexible informed negotiations between private fund parties.<sup>1072</sup>

### C. Economic Baseline

The economic baseline against which we evaluate and measure the economic effects of the final rules, including their potential effects on efficiency, competition, and capital formation, is the state of the world in the absence of the final rules. The economic analysis appropriately considers existing regulatory requirements, including recently adopted rules, as part of its economic baseline against which the costs and benefits of the final rule are measured.<sup>1073</sup>

Specifically, we consider the current business practices and disclosure practices of private fund advisers, as well as the current regulation and the forms of external monitoring and investor protections that are currently in place. In addition, in considering the current business,

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<sup>1070</sup> See *supra* section II.A.

<sup>1071</sup> See *supra* section II.C.7.

<sup>1072</sup> See *supra* sections II.E, II.F; see also *infra* sections VI.D.3, VI.D.4, VI.E.

<sup>1073</sup> See, e.g., *Nasdaq v. SEC*, 34 F.4th 1105, 1111-15 (D.C. Cir. 2022). This approach also follows SEC staff guidance on economic analysis for rulemaking. See Staff's Current Guidance on Economic Analysis in SEC Rulemaking, *supra* footnote 979 ("The economic consequences of proposed rules (potential costs and benefits including effects on efficiency, competition, and capital formation) should be measured against a baseline, which is the best assessment of how the world would look in the absence of the proposed action."); *Id.* at 7 ("The baseline includes both the economic attributes of the relevant market and the existing regulatory structure."). The best assessment of how the world would look in the absence of the proposed or final action typically does not include recently proposed actions, because doing so would improperly assume the adoption of those proposed actions. However, in some cases, proposals may impact the behavior of market participants, for example if market participants expect adoption to be likely to occur. In those cases, the effects of the proposal may be analyzed, to the extent it is possible to measure or infer changing behavior of market participants over time or in response to specific events, as part of baseline's assessment of relevant market conditions.

disclosure, and consent practices, we consider the usefulness of the information that investment advisers provide to investors about the private funds in which those investors invest, including information that may be helpful for deciding whether to invest (or remain invested) in the fund, monitoring an investment in the fund (in relation to fund documents and in relation to other funds), consenting to certain adviser activities, and other purposes. We further consider the effectiveness of current disclosures and consent practices in providing useful information to the investor. For example, fund disclosures and requirements to obtain investor consent can have direct effects on investors by affecting their ability to assess costs and returns and to identify the funds that align with their investment preferences and objectives. Disclosures and consent requirements can also help investors monitor their private fund advisers' conduct, depending in part on the extent to which private funds lack governance mechanisms that would otherwise help check adviser conduct. Disclosures and consent requirements can therefore influence the matches between investor choices of private funds and preferences over private fund terms, investment strategies, and investment outcomes, with more effective disclosures resulting in improved matches.

## **1. Industry Statistics and Affected Parties**

The final quarterly statement, audit, and adviser-led secondary rules will apply to all SEC registered investment advisers ("RIAs") with private fund clients.<sup>1074</sup> The final amendments to the books and records rule will also impose corresponding recordkeeping obligations on these advisers.<sup>1075</sup> The performance requirements of the quarterly statement rule will vary according

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<sup>1074</sup> See final rules 206(4)-10, 211(h)(1)-2, 211(h)(2)-2. As discussed above, the final rules that pertain to registered investment advisers apply to all investment advisers registered, or required to be registered, with the Commission. See *supra* section II.

<sup>1075</sup> See final amended rules 204-2(a)(20) through (23).

to whether the RIA determines the fund is a liquid fund, such as an open-end hedge fund, or an illiquid fund, such as a closed-end private equity fund.<sup>1076</sup>

According to Form ADV filing data between October 1, 2021, and September 30, 2022, there were 5,517 RIAs with private fund clients. This includes 230 RIAs to 2554 SAFs.<sup>1077</sup>

While Form ADV does not include questions for advisers to SAFs to further specify the type of securitized asset strategy the fund invests in, staff review of fund names in Form ADV indicates that SAFs are comprised of CLOs, CDOs, CBOs, and other structured products that issue asset-backed securities and primarily issue debt to their investors.<sup>1078</sup> We estimate, based on a review of fund names and their advisers in Form ADV, that funds reporting as SAFs advised by RIAs in Form ADV are almost 90% CLOs by assets under management and almost 70% by counts of funds.<sup>1079</sup> As discussed above, advisers will not be subject to the final rules with respect to their relationships with SAFs.<sup>1080</sup>

The final prohibited activity and preferential treatment rules will apply to all advisers to private funds, regardless of whether the advisers are registered with, required to be registered with, or reporting as exempt reporting advisers (“ERAs”) to the Commission or one or more State securities commissioners or are otherwise not required to register. ERAs generally rely on two possible exemptions to forgo registration: (1) an exemption for advisers that solely manage private funds and have less than \$150 million regulatory assets under management in the United

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<sup>1076</sup> See final rule 211(h)(1)-2(d).

<sup>1077</sup> Of these 230 RIAs to SAFs, 68 RIAs with combined SAF assets under management of approximately \$166 billion only advise SAFs, and 162 RIAs with combined SAF assets under management of approximately \$842 billion also manage at least one non-SAF private fund.

<sup>1078</sup> See Form ADV data between Oct. 1, 2021 and Sept. 30, 2022.

<sup>1079</sup> See Form ADV data as of Dec. 31, 2022. See also *infra* section VII.

<sup>1080</sup> See *supra* section II.A.

States, and (2) investment advisers that solely advise venture capital funds.<sup>1081</sup> To qualify as a venture capital fund, a fund must represent itself as pursuing a venture capital strategy, meet certain leverage limitations, prohibit redemptions by investors except in extraordinary circumstances, and have at least 80% of a fund's investments be direct equity investments into private companies.<sup>1082</sup>

The final amendments to the books and records rule will also impose corresponding recordkeeping obligations on private fund advisers if they are registered or required to be registered with the Commission.<sup>1083</sup> Based on Form ADV filing data between October 1, 2021, and September 30, 2022, this will include 5,517 advisers to private funds.<sup>1084</sup>

The final amendments to the compliance rule will affect all RIAs, regardless of whether they have private fund clients. According to Form ADV filing data between October 1, 2021, and September 30, 2022, there were 15,330 RIAs, across both those who did and did not have private fund clients.

The parties affected by the rules and amendments will include private fund advisers, advisers to other client types (with respect to the amendments to the compliance rule), private funds, private fund investors, certain other pooled investment vehicles and clients advised by private fund advisers and their related persons, accountants providing audits under the final audit rule, and others to whom those affected parties will turn for assistance in responding to the rules and amendments. Private fund investors are generally institutional investors (including, for example, retirement plans, trusts, endowments, sovereign wealth funds, and insurance

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<sup>1081</sup> See *supra* footnote 123

<sup>1082</sup> *Id.*

<sup>1083</sup> See final amended rules 204-2I(1), 204-2(a)(21), 204-2(a)(23), and 204-2(a)(7)(v).

<sup>1084</sup> See *infra* footnote 1845 (with accompanying text).

companies), as well as high net worth individuals. In addition, the parties affected by these rules could include private fund portfolio investments, such as portfolio companies.

The relationships between the affected parties are governed in part by current rules under the Advisers Act, as discussed in Section V.B.3. In addition, relationships between funds and investors generally depend on fund governance.<sup>1085</sup> Private funds typically lack fully independent governance mechanisms, such as an independent board of directors, that would help monitor and govern private fund adviser conduct and check possible overreaching. Although some private funds may have LPACs or boards of directors, these types of bodies may not have sufficient independence, authority, or accountability to oversee and consent to these conflicts or other harmful practices as they may not have sufficient access, information, or authority to perform a broad oversight role, and they do not have a fiduciary obligation to private fund investors.<sup>1086</sup> As a result, to the extent the adviser has a potential conflict of interest, these bodies may not be positioned to negotiate for full and fair disclosure, or may not be positioned to provide informed consent to the adviser's potential conflicts, or may not be positioned to negotiate with the adviser to eliminate or reduce conflicts.

Similarly, relationships between advisers, funds, and investors may rely on investor consent to govern fund and adviser behavior. For example, one private equity fund document template uses investor consent as a prerequisite for revising fund documents.<sup>1087</sup> Some

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<sup>1085</sup> See, e.g., Lucian Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, J. ECON. PERSPECTIVES (2017); see also John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L. J. 1231 (2014); Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSPECTIVES 161 (2004).

<sup>1086</sup> See *supra* section II.E.

<sup>1087</sup> See, e.g., *The ILPA Model Limited Partnership Agreement (Whole-of-Fund Waterfall)*, ILPA, July 2020, available at <https://ilpa.org/wp-content/uploads/2020/07/ILPA-Model-Limited-Partnership-Agreement-WOF.pdf>.

provisions may require an individual investor's consent, such as the fund documents designating that investor an "ERISA Partner," other provisions may require majority investor consent, such as changing the fund's closing date, and still further provisions may require consent of 75% or 90% of investors in interest, with interest typically excluding the interests of the adviser and its related persons, and with other certain limitations.<sup>1088</sup> For example, modifying fund documents to change the fund's investment objectives may require consent from 90% of investors in interest.<sup>1089</sup> Hedge fund advisers may also rely on consent arrangements with respect to their hedge funds, with some activities requiring positive consent, some activities requiring negative consent, and some activities such as changing an auditor only requiring notice to investors.

However, the interests of one or more private fund investors may not represent the interests of, or may otherwise conflict with the interests of, other investors in the private fund due to business or personal relationships or other private fund investments, among other factors. To the extent investors are afforded governance or similar rights, such as LPAC representation, certain fund agreements permit such investors to exercise their rights in a manner that places their interests ahead of the private fund or the investors as a whole. For example, certain fund agreements state that, subject to applicable law, LPAC members owe no duties to the private fund or to any of the other investors in the private fund and are not obligated to act in the interests of the private fund or the other investors as a whole.<sup>1090</sup> These limitations may hinder the ability for LPAC oversight, including LPAC consent, to achieve the same benefits as investor consent.

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<sup>1088</sup> *Id.*

<sup>1089</sup> *Id.*

<sup>1090</sup> LPACs may not have the necessary independence, authority, or accountability to oversee and consent to certain conflicts or other harmful practices.

Some commenters further stated that relationships between the affected parties are governed in part by reputational mechanisms and active monitoring directly by investors. For example, one commenter stated that preferential terms offered to certain investors provide flexibility for the adviser, but that if the adviser “abuses the flexibility in some way (for example, by providing some benefit to a preferred client), it imposes a reputational cost for the adviser and adversely affects the adviser’s future fundraising efforts.”<sup>1091</sup> Another commenter stated that “larger investors have strong incentives to actively monitor and communicate with their investment manager,” and that “this type of fund governance benefits all investors.”<sup>1092</sup> As a closely related matter, some commenters stated that larger investors negotiate for liquidity protections or other investor-favorable protections that, if adopted by the adviser, benefit all investors in the fund.<sup>1093</sup> However, no commenter made this argument with respect to preferential treatment secured by larger investors. That is, while larger investors’ monitoring and negotiations for certain protections may benefit all investors, the preferential terms secured by larger investors can be to the detriment of smaller investors with fewer resources to bargain with advisers.<sup>1094</sup> Lastly, while commenters stated that the Commission should consider consent requirements instead of certain of the proposed rules,<sup>1095</sup> commenters did not generally discuss the prevalence of consent requirements today with respect to the activities considered in the final rules.

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<sup>1091</sup> AIC Comment Letter I, Appendix 1.

<sup>1092</sup> MFA Comment Letter I, Appendix A.

<sup>1093</sup> *See, e.g.*, Ropes & Gray Comment Letter.

<sup>1094</sup> *See supra* section II.G; *see also infra* sections VI.C.2, VI.D.4.

<sup>1095</sup> *See, e.g.*, BVCA Comment Letter; MFA Comment Letter I; AIMA/ACC Comment Letter.



As discussed above, SAFs are special purpose vehicles or other entities that securitize assets by pooling and converting them into securities that are offered and sold in the capital markets.<sup>1096</sup> These vehicles primarily issue debt, structured as notes and issued in different tranches to investors, and paid in accordance with a waterfall established by the fund’s initial indenture agreement. The residual profits from the fund after fees, expenses, and payments to debt tranches accrue to an equity tranche of the fund. Equity tranches are typically only a small portion of the CLO, on the order of 10% of initial capital raised to purchase the CLO loan portfolio.<sup>1097</sup> However, the equity tranche of a CLO differs from typical equity interests in other private funds, in particular with respect to the composition of investors in the equity tranche. For example, based on industry data, no pension funds invest in the equity tranches of CLOs (and pension funds are only a *de minimis* portion of the most senior debt tranches of CLOs).<sup>1098</sup> One commenter stated, consistent with industry reports, that the most common equity investors are hedge funds and structured credit funds.<sup>1099</sup> Investors in the equity tranche also typically include the adviser and its related persons. Moreover, as commenters stated, most third party investors in CLOs are Qualified Institutional Buyers (“QIBs”), each of which is generally an entity that owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity, and are thus typically among the larger private fund investors.<sup>1100</sup>

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<sup>1096</sup> See *supra* section II.A.

<sup>1097</sup> See LSTA Comment Letter; SFA Comment Letter I; SIFMA-AMG Comment Letter I; TIAA Comment Letter; see also ARES MGMT. CORP., UNDERSTANDING INVESTMENTS IN COLLATERALIZED LOAN OBLIGATIONS (“CLOS”) (2020), available at <https://www.aresmgmt.com/sites/default/files/2020-02/Understanding-Investments-in-Collateralized-Loan-ObligationsvF.pdf> (last visited June 26, 2023); see also *supra* section II.A.

<sup>1098</sup> *Id.*

<sup>1099</sup> LSTA Comment Letter.

<sup>1100</sup> See LSTA Comment Letter; SFA Comment Letter I; SIFMA-AMG Comment Letter I; TIAA Comment Letter.

Some commenters stated that the governance structure of CLOs and other SAFs differ from other types of funds.<sup>1101</sup> One commenter stated, for example, that the structure of a CLO is governed by its indenture, which will describe the appointment and role of a trustee that represents the interests of the CLO investors, and a collateral administrator, both of whom are independent of the investment adviser.<sup>1102</sup> The trustee, along with a similarly unrelated collateral administrator, will maintain custody of the portfolio's assets, remit payments to investors, approve trades, generate reports for investors, and act as a representative of the investors in unusual events such as defaults or accelerations.<sup>1103</sup> The CLO will also appoint an independent CPA to perform specific procedures so the user of the results of the agreed upon procedures report can make their own determination about whether the fund follows procedures that are designed to ensure that the CLO is properly allocating cash flows, meeting the obligations in the indenture, and providing accurate information to investors.<sup>1104</sup> We understand that certain core characteristics of CLOs are generally shared across all SAFs: namely, that they are vehicles that issue asset-backed securities collateralized by an underlying pool of assets and that primarily issue debt.<sup>1105</sup> One commenter generally specified that these features are common to all asset-backed securitization vehicles, and so based on our definition we understand these features to be common to all SAFs.<sup>1106</sup>

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<sup>1101</sup> See *supra* section II.A.

<sup>1102</sup> LSTA Comment Letter.

<sup>1103</sup> *Id.*

<sup>1104</sup> *Id.*

<sup>1105</sup> See *supra* section II.A.

<sup>1106</sup> See SFA Comment Letter I; SFA Comment Letter II.

Based on Form ADV filing data between October 1, 2021, and September 30, 2022, 5,517 RIAs and 5,381 ERAs reported that they are advisers to private funds.<sup>1107</sup> Based on Form ADV data, hedge funds and private equity funds are the most frequently reported private funds among RIAs, followed by real estate and venture capital funds, as shown in Figures 1A and 1B. This pattern also holds for the number of advisers to each of these types of funds. In comparison to RIAs, ERAs have lower assets under management and are more frequently advisers to venture capital (VC) funds, followed by advisers to private equity funds and hedge funds, with advisers to real estate funds more uncommon. However, as some commenters stated, some advisers to venture capital funds may also be RIAs.<sup>1108</sup> In particular, some advisers to funds that hold themselves out as venture capital funds may not want to limit their capital allocation outside of direct equity stakes in private companies to 20% of their portfolio, and so may register to be able to hold a more diversified portfolio.<sup>1109</sup> Based on Form ADV filing data between October 1, 2021, and September 30, 2022, RIAs to venture capital funds who exceed this 20% threshold may account for as much as \$539.1 billion in gross assets.

Figure 1A:

Private Funds Reported by RIAs				
Registered Investment Advisers				
Private funds	Feeder funds	Gross assets (billions)	Advisers to Private Funds	

<sup>1107</sup> Form ADV, Item 5.F.2. and Item 12.A.

<sup>1108</sup> *See, e.g.*, Andreessen Comment Letter; NVCA Comment Letter. In general, Figures 1A and 1B illustrate that advisers often advise multiple different types of funds, as the sum of advisers to each type of fund exceeds the total number of advisers.

<sup>1109</sup> *Id.* *See also, e.g.*, David Horowitz, *Why VC Firms Are Registering as Investment Advisers*, MEDIUM.COM (Sept. 23, 2019), available at <https://medium.com/touchdownvc/why-vc-firms-are-registering-as-investment-advisers-ea5041bda28d> (discussing why Andreessen Horowitz, General Catalyst, Foundry Group, and Touchdown Ventures, among other venture capitalists, have registered as RIAs).

Any private funds	51,767	13,222	21,120.70	5,517
Hedge funds	12,442	6,815	9,728.60	2,632
Private equity funds	22,709	3,910	6,542.10	2,106
Real estate funds	4,717	976	1,017	605
Venture capital funds	3,056	199	539.1	368
Securitized asset funds	2,554	85	1,008.40	230
Liquidity funds	88	9	305.5	47
Other private funds	6,201	1,218	1,980.10	1,113

Source: Form ADV submissions filed between Oct. 1, 2021, and Sept. 30, 2022. Funds that are listed by both registered investment advisers and SEC-exempt reporting advisers are counted under both categories separately. Gross assets include uncalled capital commitments on Form ADV.

Figure 1B:

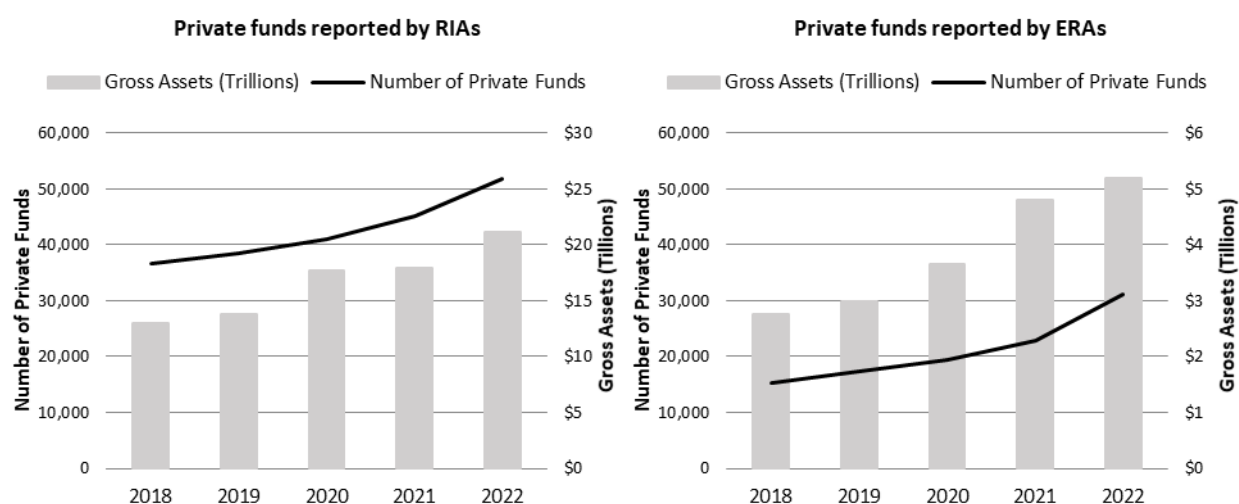
Private Funds Reported by ERAs				
	Exempt Reporting Advisers			
	Private funds	Feeder funds	Gross assets (billions)	Advisers to Private Funds
Any private funds	31,129	2,667	5,199.40	5,381
Hedge funds	2,060	1,223	1,445.50	1,205
Private equity funds	6,325	702	1,657.50	1,457
Real estate funds	849	180	374.1	242
Venture capital funds	20,627	351	1,206.10	1,994
Securitized asset funds	101	-	56.3	20
Liquidity funds	16	-	129.3	5
Other private funds	1,151	201	330.6	350

Source: Form ADV submissions filed between Oct. 1, 2021, and Sept. 30, 2022. Funds that are listed by both registered investment advisers and SEC-exempt reporting advisers are counted under both categories separately. Gross assets include uncalled capital commitments on Form ADV.

Also based on Form ADV data, the market for private fund investing has grown dramatically over the past five years. For example, the assets under management of private equity funds reported by RIAs on Form ADV during this period (from Oct. 1, 2017 to Sept. 30, 2022) grew from \$2.9 trillion to \$6.5 trillion, or by 124%. The assets under management of hedge funds reported by ERAs grew from \$7.1 trillion to \$9.7 trillion, or by 37%. The trends for private funds as a whole are given in Figure 2. The assets under management of all private funds

reported by RIAs grew by 62% over the past five years from \$13 trillion to over \$21 trillion, while the number of private funds reported by RIAs grew by 42% from 36.5 thousand to 51.7 thousand. The assets under management of all private funds reported by ERAs grew by 89% over the past five years from \$2.75 trillion to over \$5.2 trillion, while the number of private funds reported by ERAs grew by 105% from 15.2 thousand to 31.1 thousand, as shown in Figure 2A.<sup>1110</sup> There has lastly been similar growth in the number of private fund advisers, as the number of RIAs advising at least one private fund grew from 4,783 in 2018 to 5,517 in 2022, and the number of ERAs advising at least one private fund grew from 3,839 in 2018 to 5,381 in 2022, as shown in Figure 2B.

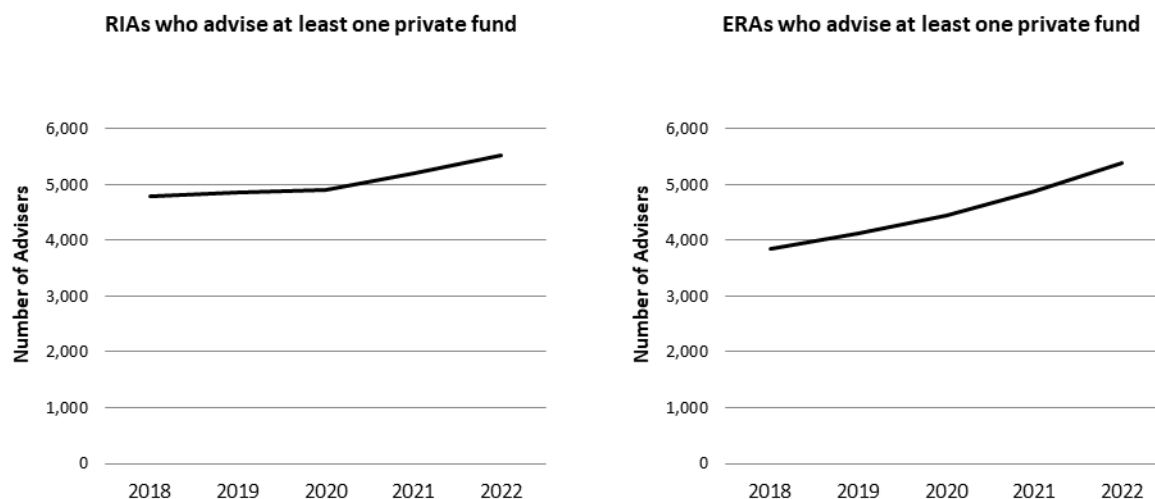
Figure 2A:



Source: Form ADV submissions filed between Oct. 1, 2017, and Sept. 30, 2022.

Figure 2B:

<sup>1110</sup> See Form ADV data.



Source: Form ADV submissions filed between Oct. 1, 2017, and Sept. 30, 2022.

Despite commenter assertions that all private fund investors are sophisticated and can “fend for themselves,”<sup>1111</sup> the staff have also observed a trend of rising interest in private fund investments by smaller investors, who may have sufficient capital to meet the regulatory requirements to invest in private funds but lack experience with the complexity of private funds and the practices of their advisers. While we do not believe there exists industry-wide data on the prevalence of investors of different levels of sophistication in private funds over time, there has been a distinct trend of media coverage and public interest in expanding private fund investing access. Platforms have emerged to facilitate individual investor access to private investments with small investment sizes.<sup>1112</sup> News outlets have reported other instances of amateur investor groups investing in private equity, or other instances of smaller individual

<sup>1111</sup> See *supra* section VI.B; see also, e.g., AIC Comment Letter I, Appendix 2.

<sup>1112</sup> See, e.g., *Private Equity Investments*, MOONFARE, available at <https://www.moonfare.com/private-equity-investments>; *About Us*, YIELDSTREET, available at <https://www.yieldstreet.com/about/> (“For decades, institutions and hedge funds have trusted private markets to grow their portfolios. Yieldstreet was founded in 2015 to unlock alternatives for more investors than ever before.”).

investors accessing private investments.<sup>1113</sup> There is also evidence that this trend will continue into the future, with potential ongoing rising participation in private funds by smaller investors with less bargaining power. One industry white paper found 80% of surveyed private fund advisers and 72% of surveyed private fund investors said non-accredited individuals should be able to invest in private markets.<sup>1114</sup> A 2022 survey of private market investors found that young individual investors were expressing increased demand for alternative investments, and that large private market firms are building out retail distribution capabilities and vehicles, providing greater access to private markets for individual portfolios.<sup>1115</sup> Even absent any changes in relevant law that would allow currently non-accredited individuals, or retail investors, greater access, these data points indicate rising interest and likelihood of rising future participation by more vulnerable investors in private funds.<sup>1116</sup>

Private funds and their advisers also play an increasingly important role in the lives of millions of Americans. Some of the largest groups of private fund investors include State and municipal pension plans, college and university endowments, non-profit organizations, and high net worth individuals.<sup>1117</sup> According to the U.S. Census Bureau, public sector retirement

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<sup>1113</sup> See, e.g., Paul Sullivan, *D.I.Y. Private Equity is Luring Small Investors*, N.Y. TIMES (July 19, 2019); *How Can Smaller Investors Obtain Access to Private Equity Investment*, THE NEST, available at <https://budgeting.thenest.com>; Nathan Tipping, *Private Equity is Finding Ways to Attract Smaller Investors*, RISK.NET (May 20, 2022), available at <https://www.risk.net/investing/7948681/private-equity-is-finding-ways-to-attract-smaller-investors>.

<sup>1114</sup> SEI, PRIVATE MARKET LIQUIDITY: ILLOGICAL OR INSPIRED? (2021), available at <https://www.sei.com/sites/default/files/2022-05/SEI-IMS-Private-Market-Liquidity-WhitePaper-2021-US.pdf>.

<sup>1115</sup> McKinsey & Co., *US Wealth Management: A Growth Agenda for the Coming Decade* (Feb. 16, 2022), available at <https://www.mckinsey.com/industries/financial-services/our-insights/us-wealth-management-a-growth-agenda-for-the-coming-decade>.

<sup>1116</sup> For example, retail investors may continue increasing their participation in investor groups with pooled funds. See *supra* footnote 1113.

<sup>1117</sup> See, e.g., Professor Clayton Public Investors Article, *supra* footnote 12.

systems play a role in retirement savings for 15 million active working members and 11.7 million retirees.<sup>1118</sup>

Private fund advisers have also sought to be included in individual investors' retirement plans, including their 401(k)s,<sup>1119</sup> and some large private equity firms have created new private funds aimed at individual investors.<sup>1120</sup>

## **2. Sales Practices, Compensation Arrangements, and Other Business Practices of Private Fund Advisers**

The relationship between the adviser and the private fund client in which the investor is participating begins with the investor conducting initial screening for private funds that meet the investor's specified criteria, potentially with the assistance of investment consultants.<sup>1121</sup> As noted above, many investors' internal diversification requirements and objectives and underwriting standards generally leave them with a smaller pool of advisers with whom they can negotiate.<sup>1122</sup> Many investors also face complex internal administrative and state regulatory requirements that govern their negotiations with advisers that they contact. For example, for retirement plans, investment committees who are responsible for determining plan strategy are often established by a plan sponsor, an investment board is formed, and the board acts according

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<sup>1118</sup> *National Data*, PUBLICPLANSDATA.ORG, available at <https://publicplansdata.org/quick-facts/national/#:%7E:text=Collectively%2C%20these%20plans%20have%3A,members%20and%2011.7%20million%20retirees> (last visited May 30, 2023).

<sup>1119</sup> See, e.g., Dep't of Labor, Info. Letter (June 3, 2020), available at <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020>.

<sup>1120</sup> See, e.g., *Blackstone, Other Large Private-Equity Firms Turn Attention to Vast Retail Market*, WALL ST. J. (June 7, 2022), available at <https://www.wsj.com/articles/blackstone-other-large-private-equity-firms-turn-attention-to-vast-retail-market-11654603201> (retrieved from Factiva database).

<sup>1121</sup> Advisers may also instead seek and identify investors through multiple potential channels.

<sup>1122</sup> See, e.g., ILPA Comment Letter II; NY State Comptroller Comment Letter; see also, e.g., Pension Funds, *supra* footnote 985.



to an investment policy statement and charter. A survey by Plan Sponsor Council of America found that 95% of organizations that sponsor defined contribution retirement plans had such a committee, with 78% of them being established with formal legal documents.<sup>1123</sup> These percentages are both higher for organizations with a large number of participants. Investment committees then report portfolio performance strategy, plans, and results to the plan sponsor and other key stakeholders.<sup>1124</sup> This includes a determination of asset allocations for a portfolio, which an investment committee may make up to several years ahead of actual deployment of capital to those allocations. For example, CalPERS determines its asset mix on a four-year cycle, with the determination being made nearly a year before beginning its implementation.<sup>1125</sup> As another example, advisers may also face State pay-to-play or anti-boycott laws.<sup>1126</sup>

Once investors identify potential advisers, they enter into negotiations to determine whether they will invest in one or more of the adviser’s private fund clients. The process during which fund terms may be disclosed and negotiated before investors commit to investing in a fund is known as the “closing process.”<sup>1127</sup> For closed-end, illiquid funds, such as private equity funds, there may be a series of closings from the initial closing to the final closing, after which new investors may generally not be admitted to the fund. The end of the fundraising period is

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<sup>1123</sup> See PSCA, *Retirement Plan Committees*, available at [https://www.psc.org/sites/psc.org/files/Research/2021/2021%20Snapshot\\_Ret%20Plan%20Com\\_FINAL.pdf](https://www.psc.org/sites/psc.org/files/Research/2021/2021%20Snapshot_Ret%20Plan%20Com_FINAL.pdf)

<sup>1124</sup> See, e.g., Illinois Municipal Retirement Fund Investment Committee Charter, available at <https://www.imrf.org/en/investments/policies-and-charter/investment-committee-charter>.

<sup>1125</sup> See *California Public Employees’ Retirement System Asset Liability Management Policy*, CALPERS, available at [https://www.calpers.ca.gov/docs/board-agendas/202009/financeadmin/item-6b-01\\_a.pdf](https://www.calpers.ca.gov/docs/board-agendas/202009/financeadmin/item-6b-01_a.pdf).

<sup>1126</sup> See *supra* sections II.A, II.G.1.

<sup>1127</sup> See, e.g., Seth Chertok & Addison D. Braendel, *Closed-End Private Equity Funds: A Detailed Overview of Fund Business Terms, Part I*, 13 J. PRIV. EQUITY 33 (Spring 2010).

the final closing date. For open-end, liquid funds, such as hedge funds, the closing process for allowing new investors to commit may be ongoing over the life of the fund.

Because different investors may receive disclosures or opportunities to negotiate over fund terms at different times, private funds face a fundamental incentive obstacle in making successful closings: later investors may be able to ask the fund adviser what contractual terms were awarded to early investors, and armed with that information they may attempt to negotiate contractual terms at least as good as the early investors. This is one of several difficulties advisers may currently face in successfully closing early investors into a private fund, as the early investor has an incentive to wait for the latest possible opportunity to close.<sup>1128</sup> New emerging advisers may also not have established reputations yet, and earlier investors may have to conduct supplemental due diligence on the adviser. Later investors can freeride on the due diligence, and resulting negotiated terms, conducted by earlier investors.<sup>1129</sup>

There are two leading ways that advisers may currently overcome these operational difficulties with respect to the closing process. First, an adviser may allow investors, particularly early investors, to have MFN status. An MFN investor may have, for example, subject to certain restrictions, the ability to receive substantially the same rights granted by the fund or the adviser in any side letter or similar agreement that are materially different from the rights granted to the MFN investor.<sup>1130</sup> These MFN rights can come with certain restrictions, such as not having the ability to receive any rights granted to an investor with a capital commitment in excess of the

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<sup>1128</sup> *Id.*

<sup>1129</sup> See, e.g., George Fenn, Nellie Liang & Stephen Prowse, *The Private Equity Market: An Overview*, 6 FIN. MKTS., INST., & INSTRUMENTS, at 50 (Nov. 1997).

<sup>1130</sup> See, e.g., William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. (2017).

MFN investor's commitment.<sup>1131</sup> Second, an adviser may convince investors that the adviser can credibly commit to terms that will be more advantageous than the investor could receive by waiting. One possible path to this credibility would be for the adviser to establish a reputation for this behavior.

Once the closing process is complete, investors are participants in the adviser's private fund client, and the adviser has a fiduciary duty to the private fund client that is comprised of a duty of care and a duty of loyalty enforceable under the antifraud provision of Section 206.<sup>1132</sup> Many commenters cited the existing fiduciary duty in their comment letters.<sup>1133</sup> The duty of loyalty requires that an adviser not subordinate its private fund client's interests to its own.<sup>1134</sup> Private fund advisers are also prohibited from engaging in fraud more generally under the general antifraud provisions of the Federal securities laws, including section 10(b) of the Exchange Act (and 17 CFR 240.10b-5 ("rule 10b-5") thereunder) and section 17(a) of the Securities Act.<sup>1135</sup> As discussed above, we believe that certain activities that we proposed to specifically prohibit are already inconsistent with an adviser's existing fiduciary duty, namely charging fees for unperformed services and attempting to waive an adviser's compliance with its

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<sup>1131</sup> See, e.g., *MFN Clause Sample Clauses*, LAW INSIDER, available at <https://www.lawinsider.com/clause/mfn-clause>.

<sup>1132</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5. Investment advisers also have antifraud liability with respect to prospective clients under section 206 of the Advisers Act, which, among other aspects, applies to transactions, practices, or courses of business which operate as a fraud or deceit upon prospective clients.

<sup>1133</sup> See, e.g., SIFMA-AMG Comment Letter I; PIFF Comment Letter.

<sup>1134</sup> See 2019 IA Fiduciary Duty Interpretation, *supra* footnote 5. The duty of care includes, among other things: (i) the duty to provide advice that is in the best interest of the private fund client, (ii) the duty to seek best execution of a private fund client's transactions where the adviser has the responsibility to select broker-dealers to execute private fund client trades, and (iii) the duty to provide advice and monitoring over the course of the relationship with the private fund client. *Id.* The final rules predominantly relate to issues regarding the duty of loyalty and not the duty of care.

<sup>1135</sup> Advisers' dealings with private fund investors may also implicate the antifraud provisions of the Federal securities laws depending on the facts and circumstances.

Federal antifraud liability for breach of fiduciary duty to the private fund or with any other provision of the Advisers Act.<sup>1136</sup>

Private fund advisers are also subject to rule 206(4)-8 under the Advisers Act, which prohibits investment advisers to pooled investment vehicles, which include private funds, from (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

Despite existing fiduciary duties, existing antifraud provisions of section 206 and the other Federal securities laws, and existing rule 206(4)-8, there are no current particularized requirements that deal with many of the revised requirements in the final rule. For example, there is no current Federal regulation requiring a private fund adviser to disclose multiple different measures of performance to its investors, to refrain from borrowing from a private fund client without disclosure or investor consent, to obtain a fairness opinion or valuation opinion from an independent opinion provider when leading secondary transactions, or to disclose preferential treatment of certain investors to other investors.<sup>1137</sup>

In the absence of more particularized requirements, we have observed business practices of private fund advisers that enrich advisers without providing any benefit of services to the private fund and its underlying investors or that create incentives for an adviser to place its own

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<sup>1136</sup> See *supra* section II.E.

<sup>1137</sup> State laws generally require disclosure of information that would not have a material, negative effect on other investors, such as fee and expense transparency. See *supra* footnote 854 and accompanying text.

interests ahead of the private fund’s interests. For example, as discussed above, some private fund advisers or their related persons have entered into arrangements with a fund’s portfolio investments to provide services which permit the adviser to accelerate the unpaid portion of fees upon the occurrence of certain triggering events, even though the adviser will never provide the contracted-for services.<sup>1138</sup> These fees enrich advisers without providing the benefit of any services to the private fund and its underlying investors. As stated above, even absent a particularized requirement, we believe charging fees for unperformed services is inconsistent with an adviser’s fiduciary duty and may also violate antifraud provisions of the Federal securities laws on grounds other than an undisclosed breach of the adviser’s fiduciary duty, even if disclosed and even if investors consented.<sup>1139</sup>

The Proposing Release cited a trend in the industry where certain advisers charge a private fund for fees and expenses incurred by the adviser in connection with the establishment and ongoing operations of its advisory business.<sup>1140</sup> The Proposing Release recognized, for example, that certain private fund advisers, most notably for hedge funds that utilize a “pass-through” expense model, employ an arrangement where the private fund pays for most, if not all, of the adviser’s expenses, and that in exchange, the adviser does not charge a management, advisory, or similar fee.<sup>1141</sup> The adviser does charge an incentive or performance fee on net returns of the private fund.<sup>1142</sup> However, commenters stated that the Proposing Release did not demonstrate any economic problems with pass-through expense models, and stated the pass-

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<sup>1138</sup> See *supra* section II.E.

<sup>1139</sup> *Id.*

<sup>1140</sup> Proposing Release, *supra* footnote 3, at 140.

<sup>1141</sup> *Id.*

<sup>1142</sup> *Id.*

through expense models should not be prohibited.<sup>1143</sup> Other commenters stated that pass-through expense models are often optimal outcomes of negotiations, and that pass-through expense models still provide incentives for advisers to minimize expenses.<sup>1144</sup>

However, we continue to believe that, to the extent advisers charge to a private fund certain expenses that benefit the adviser more than the investors, such as fees and expenses related to regulatory, compliance, and examination costs, and expenses related to investigations of the adviser or its related persons by any governmental or regulatory authority, that practice represents a potentially economically problematic outcome.<sup>1145</sup> This is because, since these expenses may benefit the adviser more directly than the investors, including where the expense pertains to an investigation of the adviser or its related persons by any governmental or regulatory authority, any instance of this practice occurring risks representing an exercise of the adviser's bargaining power in securing contractual terms allowing these expenses.<sup>1146</sup> Some investors may not anticipate the performance implications of these costs, or may avoid investments out of concern that such costs may be present.<sup>1147</sup> This could lead to a mismatch between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes, relative to what would occur in the absence of such unexpected or uncertain costs.

Whether such arrangements distort adviser incentives to pay attention to compliance and legal matters, including matters related to investigations of potential conflicts of interest, may

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<sup>1143</sup> See, e.g., Sullivan & Cromwell Comment Letter; ATR Comment Letter; Comment Letter of James A. Overdahl, Ph.D., Partner, Delta Strategy Group (Apr. 25, 2022) ("Overdahl Comment Letter").

<sup>1144</sup> See, e.g., Overdahl Comment Letter.

<sup>1145</sup> See *supra* section II.E.2.a).

<sup>1146</sup> *Id.*

<sup>1147</sup> See *supra* section VI.B.

vary from adviser to adviser. This is because adviser-level attention to compliance and legal matters can depend on both investor and adviser risk preferences. As one commenter stated, in some cases, if advisers bear the cost of compliance, including costs of compliance for investigations by government or regulatory authorities, advisers may have incentives to recommend investments that are less diversified.<sup>1148</sup> We agree with this possibility. For example, complex investment strategies may require significant registration with multiple regulators and reporting in multiple jurisdictions. The additional compliance work on the part of the adviser to execute a more complex investment strategy can be to the benefit of investors in the fund. By contrast, as the same commenter stated, if investors bear the cost, then so long as disclosures are made the investors can decide for themselves whether they are willing to pay extra compliance costs to achieve better diversification (or, in other cases, higher risks and thus higher potential returns).<sup>1149</sup>

However, we also continue to believe that, when investors bear the costs, advisers may have distorted incentives with respect to their treatment of compliance and legal matters, namely incentives to pay suboptimal attention to these matters. Advisers who pay suboptimal attention to compliance costs, for example, receive profits associated with their reduced compliance expenses, but in doing so generate risks that may be borne by investors. Thus, for some advisers, funds, and their investors, it may align economic incentives for the fund (and, by extension, the investors) to bear regulatory, compliance, and examination costs, and expenses related to investigations of the adviser or its related persons by any governmental or regulatory authority.

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<sup>1148</sup> See, e.g., Weiss Comment Letter; Maskin Comment Letter.

<sup>1149</sup> *Id.*

In other cases, it may better align economic incentives for the adviser to bear these expenses, if the benefits from undertaking the expenses primarily accrue to the adviser.

Even when investors may benefit from bearing these costs, full disclosure is necessary and investors may not be able to secure such disclosures today. As the above commenter stated, even when economic incentives are aligned by investors bearing the costs of compliance expenses, it is so that the investor can determine for themselves the appropriate magnitude of compliance expenses (subject to minimum required amounts of expenses, for example minimum expenses necessary for compliance with rule 206(4)-7).<sup>1150</sup> This requires disclosure, but we believe that allocation of these types of fees and expenses to private fund clients can be deceptive in current market practice. For example, investors may be deceived to the extent the adviser does not disclose the total dollar amount of such fees and expenses before charging them. These expenses may also change over time in ways not expected by investors, requiring consistent ongoing disclosures. Investors may also be deceived if advisers describe such fees and expenses so generically as to conceal their true nature and extent.<sup>1151</sup>

As a final matter, we believe that these considerations vary according to the type of expense. For regulatory, compliance, and examination expenses, the risk of distorted adviser incentives when the investor bears the costs may be comparatively low, and with disclosure many investors may prefer to bear these costs and determine appropriate allocation of fund resources towards these expenses themselves. For example, investors are more likely to have varying preferences over whether the adviser hires a compliance consultant, the scope of legal

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<sup>1150</sup> *Id.*

<sup>1151</sup> *See supra* section II.E.1.a), II.E.2.a).



services that will be provided to the fund, or whether the fund will conduct mock examinations in order to prepare for real examinations.

Meanwhile, the risk of distorted adviser incentives may be higher in the case of investors bearing the costs of investigations by government or regulatory authorities. A fund in which the adviser, without having secured consent from investors, is able to pass on expenses associated with an investigation has adverse incentives to engage in conduct likely to trigger an investigation. While reputational effects may mitigate the effects of these adverse incentives, as advisers who pass on such expenses may be less able to attract investors in the future, reputational effects do not resolve these effects. Examinations may not necessarily implicate the adviser's wrongdoing,<sup>1152</sup> but investigations may carry a higher risk of such an implication. In particular, we do not believe there are reasonable cases where incentives are aligned by investors bearing the costs of investigations by government or regulatory authorities that result or have resulted in the governmental or regulatory authority, or a court of competent jurisdiction, sanctioning the adviser or its related persons for violating the Act or the rules thereunder. Our staff has also observed instances in which advisers have entered into agreements that reduce the amount of clawbacks by taxes paid, or deemed to be paid, by the adviser or its owners without sufficient disclosure as to the effects of these clawbacks,<sup>1153</sup> and instances in which limited partnership agreements limit or eliminate liability for adviser misconduct.<sup>1154</sup> While these agreements are negotiated between fund advisers and investors, as discussed above advisers

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<sup>1152</sup> *Id.*

<sup>1153</sup> *See supra* section II.E.1.b). Form PF recently was revised to include new reporting requirements (though the effective date has not arrived) requiring large private equity fund advisers (*i.e.*, those with at least \$2 billion in regulatory assets under management as of the last day of the adviser's most recently completed fiscal year) to report annually on the occurrence of general partner and limited partner clawbacks. Form PF Release, *supra* footnote 564.

<sup>1154</sup> *See supra* section II.E.

often have discretion over the timing of fund payments, and so may have greater control over risks of clawbacks than anticipated by investors.<sup>1155</sup> As such, reducing the amount of clawbacks by actual, potential, or hypothetical taxes can therefore pass an unnecessary and avoidable cost to investors when the investor has insufficient transparency into the effect of the taxes on the clawback. This cost, when not transparent to the investor, denies the investor the opportunity to understand the potential restoration of distributions or allocations to the fund that it would have been entitled to receive in the absence of an excess of performance-based compensation paid to the adviser or a related person. These clawback terms can therefore reduce the alignment between the fund adviser's and investors' interests when not properly disclosed. However, as many commenters stated, because this practice is widely implemented and negotiated, we do not believe there is a risk of investors being unable, today, to refuse to consent to this practice and being harmed as a result of being unable to consent to this practice.<sup>1156</sup>

We have also observed some cases where private fund advisers have directly or indirectly (including through a related person) borrowed from private fund clients.<sup>1157</sup> This practice carries a heightened risk of investor harm because the adviser faces a direct conflict of interest: The adviser's interests are on both sides of the borrowing transaction. This conflict of interest may result in the adviser borrowing from the fund even when it is harmful to the fund. For example, the fund client may be prevented from using borrowed assets to further the fund's investment strategy, and so the fund may fail to maximize the investor's returns. This risk is relatively higher for those investors that are not able to negotiate or directly discuss the terms of the

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<sup>1155</sup> See *supra* section II.E.1.b).

<sup>1156</sup> See *supra* section II.E.1.b).

<sup>1157</sup> See *supra* section II.E.2.b).

borrowing with the adviser, and for those funds that do not have an independent board of directors or LPAC to review and consider such transactions.<sup>1158</sup>

However, as commenters stated, advisers may also borrow from funds in cases where it is beneficial to the fund and its investors for the adviser to do so, such as borrowing to facilitate tax advances,<sup>1159</sup> borrowing arrangements outside of the fund structure,<sup>1160</sup> and the activity of service providers that are affiliates of the adviser, especially with large financial institutions that play many roles in a private fund complex.<sup>1161</sup> Therefore, whether an adviser borrowing from a fund is harmful to the fund varies not only from adviser to adviser and from fund to fund, but also varies according to each individual instance of the adviser borrowing, as the harm or benefit to the fund depends on the facts and circumstances surrounding that specific borrowing activity.

As a final matter, unlike the case of adviser-led secondaries, it can be easier to reduce the risk of this conflict of interest distorting the terms, price, or interest rate of the fund's loan to the adviser with disclosure and consent practices.<sup>1162</sup> This is because the fund's investors can, if the borrow is disclosed and investor consent is sought, compare the terms of the loan to publicly available commercial rates to determine if the terms are appropriate given market conditions, or may generally withhold consent if they perceive a conflict of interest. However, we do not understand that such disclosures and consent practices are always implemented today.<sup>1163</sup>

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<sup>1158</sup> *Id.*

<sup>1159</sup> Tax advances occur when the private fund pays or distributes amounts to the general partner to allow the general partner to cover tax obligations.

<sup>1160</sup> *See* SBAI Comment Letter; CFA Comment Letter I; AIC Comment Letter I.

<sup>1161</sup> *See* IAA Comment Letter II.

<sup>1162</sup> *See infra* section VI.C.4.

<sup>1163</sup> *See supra* section II.E.2.b).

The staff also has observed harm to investors when advisers lead co-investments, leading multiple private funds and other clients advised by the adviser or its related persons to invest in a portfolio investment.<sup>1164</sup> In those instances, the staff observed advisers allocating fees and expenses among those clients on a non pro rata basis, resulting in some fund clients (and investors in those funds) being charged relatively higher fees and expenses than other clients.<sup>1165</sup> This may particularly occur when one co-investment vehicle is made up of larger investors with specific fee and expense limits.<sup>1166</sup> Advisers may make these decisions to avoid charging some portion of fees and expenses to funds with insufficient resources to bear their pro rata share of expenses related to a portfolio investment (whether due to insufficient reserves, the inability to call capital to cover such expenses, or otherwise) or funds in which the adviser has greater interests. These non pro rata allocations may also occur if an investor's side letter has reached an expense cap, or if an investor's side letter negotiates that the investor will not bear a particular type of expense. More generally, in any type of private fund, an adviser may choose to charge or allocate lower fees and expenses to a higher fee paying client to the detriment of a lower fee paying client. However, commenters stated that investors may also often benefit from these co-investment opportunities,<sup>1167</sup> and the benefit to main fund investors may fairly and equitably lead to non-pro rata allocations of expenses. Commenters also stated that expenses may be generated disproportionately by one fund investing in a portfolio company, and so non-pro rata allocations that charge such expenses entirely to one fund could also be fair and equitable.<sup>1168</sup> For example,

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<sup>1164</sup> See *supra* section II.E.1.c).

<sup>1165</sup> *Id.*

<sup>1166</sup> *Id.*

<sup>1167</sup> *Id.*

<sup>1168</sup> *Id.*

this could occur under a bespoke structuring arrangement for one private fund client to participate in the portfolio investment.<sup>1169</sup> However, our staff understand that investors today may not always receive disclosure of such non-pro rata allocations or the reasons for those allocations.<sup>1170</sup>

The staff also has observed harm to investors from disparate treatment of investors in a fund. For example, our staff has observed scenarios where an adviser grants certain private fund investors and/or investments in similar pools of assets with better liquidity terms than other investors.<sup>1171</sup> These preferential liquidity terms can disadvantage other fund investors or investors in a similar pool of assets if, for instance, the preferred investor is able to exit the private fund or pool of assets at a more favorable time.<sup>1172</sup> Similarly, private fund advisers, in some cases, disclose information about a private fund's investments to certain, but not all, investors in a private fund, which can result in profits or avoidance of losses among those who were privy to the information beforehand at the expense of those kept in the dark.<sup>1173</sup> Currently, many investors need to engage in their own research regarding what terms may be obtained from advisers, as well as whether other investors are likely to be obtaining better terms than those they are initially offered.

We believe that it may be hard for many investors, even with full and fair disclosure and if investor consent is obtained, to understand the future implications of materially harmful contractual terms, in particular when certain investors are granted preferential liquidity terms or

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<sup>1169</sup> *Id.*

<sup>1170</sup> *Id.*

<sup>1171</sup> *See supra* section II.F.

<sup>1172</sup> *Id.*

<sup>1173</sup> *Id.*

preferential information, at the time of investment and during the investment. Further, some investors may find it relatively difficult to negotiate agreements that would fully protect them from bearing unexpected portions of fees and expenses or from other decreases in the value of investments associated with these practices. For example, some forms of negotiation may occur through repeat-dealing that may not be available to some smaller private fund investors. While commenters argue that many investors are sophisticated, for whom disclosure may suffice, other smaller investors may be more vulnerable and thus still be harmed even with disclosure and if investor consent is obtained.<sup>1174</sup> As another example, to the extent investors accept these terms because of their inability to coordinate their negotiations, they would still be unable to coordinate their negotiations even if consent was sought from each individual investor for a particular adviser practice.<sup>1175</sup> Majority consent mechanisms, even to the extent they are implemented today, may have minimal ability to protect disadvantaged investors specifically in the case of preferred investors with sufficient bargaining power securing preferential terms over disadvantaged investors, as we would expect larger, preferred investors to outvote the disadvantaged investors.<sup>1176</sup> For any investors affected by these issues, there may be mismatches between investor choices of private funds and preferences over private fund terms, investment strategies, and investment outcomes, relative to what would occur in the absence of such unexpected or uncertain costs.

Our staff has also observed that investors are generally not provided with detailed information about broader types of preferential terms.<sup>1177</sup> This lack of transparency prevents

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<sup>1174</sup> See *supra* sections VI.B, VI.C.1.

<sup>1175</sup> See *supra* section VI.B.

<sup>1176</sup> *Id.*

<sup>1177</sup> See *supra* section II.G.

investors from understanding the scope or magnitude of preferential terms granted, and as a result, may prevent such investors from requesting additional information on these terms or other benefits that certain investors, including the adviser's related persons or large investors, receive. In this case, these investors may simply be unaware of the types of contractual terms that could be negotiated, and may not face any limitations over their ability to consent to these terms or their ability to negotiate these terms once the terms are sufficiently disclosed. To the extent this lack of transparency affects investor choices of where to allocate their capital, it can result in mismatches between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes.

### **3. Private Fund Adviser Fee, Expense, and Performance Disclosure Practices**

Current rules under the Advisers Act do not require advisers to provide quarterly statements detailing fees and expenses (including fees and expenses paid to the adviser and its related persons by portfolio investments) to private fund clients or to fund investors. The custody rule does, however, generally require registered advisers whose private fund clients are not undergoing a financial statement audit to have a reasonable basis for believing that the qualified custodians that maintain private fund client assets provide quarterly account statements to the fund's limited partners. Those account statements may contain some of this information, though in our experience certain fees and expenses typically are not presented with the level of detail the final quarterly statement rule will require. In addition, Form ADV Part 2A ("brochure") requires certain information about a registered adviser's fees and compensation. For example, Part 2A, Item 6 of Form ADV requires a registered adviser to disclose in its brochure whether the adviser accepts performance-based fees, whether the adviser manages both

accounts that are charged a performance-based fee and accounts that are charged another type of fee, and any potential conflicts. The information on Form ADV is available to the public, including private fund investors, through the Commission’s Investment Adviser Public Disclosure (“IAPD”) website.<sup>1178</sup> We understand that many prospective fund investors obtain the brochure and other Form ADV data through the IAPD public website.

Similarly, there currently are no requirements under current Advisers Act rules for advisers to provide investors with a quarterly statement detailing private fund performance, although advisers are subject to the antifraud provisions of the federal securities laws and any relevant requirements of the marketing rule and private placement rules. Although our recently adopted marketing rule contains requirements that pertain to displaying performance information and providing information about specific investments in adviser advertisements, these requirements do not *compel* the adviser to provide performance information to all private fund clients or investors. Rather, the requirements apply when an adviser *chooses* to include performance or address specific investments within an advertisement.<sup>1179</sup>

Form PF requires certain additional fee, expense, and performance reporting, but unlike Form ADV, Form PF is not an investor-facing disclosure form. Information that private fund advisers report on Form PF is provided to regulators on a confidential basis and is nonpublic.<sup>1180</sup>

Form PF recently was revised to include new current reporting requirements (though the

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<sup>1178</sup> Advisers generally are required to update disclosures on Form ADV on both an annual basis, or when information in the brochure becomes materially inaccurate. Additionally, although advisers are not required to deliver the Form ADV Part 2A brochure to private fund investors, many private fund advisers choose to provide the brochure to investors as a best practice.

<sup>1179</sup> The marketing rule’s compliance date was Nov. 4, 2022. As discussed above, the marketing rule and its specific protections generally will not apply in the context of a quarterly statement. *See supra* footnote 312.

<sup>1180</sup> Commission staff publish quarterly reports of aggregated and anonymized data regarding private funds on the Commission’s website. *See* Form PF Statistics Report, *supra* at footnote 12.



effective date has not arrived) requiring large hedge fund advisers to qualifying hedge funds (*i.e.*, hedge funds with a net asset value of at least \$500 million) to file a current report with the Commission when their funds experience certain stress events, several of which may affect the fund's performance.<sup>1181</sup> However, Form PF reporting, both in its regularly scheduled reporting and in its current reporting, often only requires reporting on the basis of how advisers report information to investors. For example, Form PF Section 1A, Item C, Question 17 requires reporting of gross performance and performance net of management fees, incentive fees, and allocations "as reported to current and prospective investors (or, if calculated for other purposes but not reported to investors, as so calculated)" and requires reporting "only if such results are calculated for the reporting fund (whether for purposes of reporting to current or prospective investors or otherwise)."<sup>1182</sup> Similarly, the events in the current reporting framework that rely on performance measurements are based on the fund's "reporting fund aggregate calculated value," which only requires valuation of positions "with the most recent price or value applied to the position for purposes of managing the investment portfolio" and need not be subject to fair valuation procedures.<sup>1183</sup>

Within this framework, advisers have exercised discretion in responding to the needs of private fund investors for periodic statements regarding fees, expenses, and performance or similar information on their current investments, and we discuss this variety in practices throughout this section. Broadly, current investors often use this information in determining whether to invest in subsequent funds and investment opportunities with the same adviser, or to

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<sup>1181</sup> Form PF Release, *supra* footnote 564. Advisers to private equity funds must file new quarterly reports on the occurrence of certain events, in particular the execution of an adviser-led secondary transaction. *See infra* sections VI.C.4, VI.D.6.

<sup>1182</sup> Form PF Release, *supra* footnote 564.

<sup>1183</sup> *Id.*

pursue alternative investment opportunities. When fund advisers raise multiple funds sequentially, they often consider current investors to also be prospective investors in their subsequent funds, and so may make disclosures to motivate future capital commitments. The format, scope and reporting intervals of these disclosures vary across advisers and private funds. Some disclosures provide limited information while others are more detailed and complex. A private fund adviser may agree, contractually or otherwise, to provide disclosures to a fund investor, and on the details of these disclosures, at the time of the investment or subsequently. A private fund adviser also may provide such information in the absence of an agreement. The flexibility in these options has led to the development of diverse approaches to the disclosure of fees, expenses, and performance, resulting in informational asymmetries among investors in the same private fund.<sup>1184</sup>

The private equity investor industry group ILPA, observing the variation in reporting practices across funds, has suggested the use of a standardized template for this purpose.<sup>1185</sup> In its comment letter, ILPA cited that in 2021, 59% of private equity LPs in a survey reported receiving the template more than half the time, indicating that LPs must continue to use their negotiating resources to receive the template, and many private equity investors do not receive it at all.<sup>1186</sup> Ongoing experience demonstrates that advisers do not provide the same transparency to all investors: In a more recent survey, 56% of private equity investor respondents indicated that information transparency requests granted to one investor are generally not granted to all investors, and 75% find that an adviser's agreement to report fees and expenses consistent with

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<sup>1184</sup> See, e.g., Professor Clayton Public Investors Article, *supra* footnote 12.

<sup>1185</sup> See, e.g., *Reporting Template*, ILPA, available at <https://ilpa.org/reporting-template/>. ILPA is a trade group for investors in private funds.

<sup>1186</sup> ILPA Comment Letter I; see also ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983, at 17.

the ILPA reporting template was made through the side letter, or informally, and not reflected in the fund documents presented to all investors.<sup>1187</sup>

Investors may, as a result, find it difficult to assess and compare alternative fund investments, which can make it harder to allocate capital among competing fund investments or among private funds and other potential investments. In one industry survey, 55% of respondents either disagreed or strongly disagreed that the reporting provided by advisers across fees, expenses, and performance provides the needed level of transparency.<sup>1188</sup> Limitations in required disclosures by advisers may therefore result in mismatches between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes.

While a variety of practices are used, as the market for private fund investing has grown, some patterns have emerged. We understand that most private fund advisers currently provide current investors with quarterly reporting, and many private fund advisers contractually agree to provide fee, expense, and performance reporting.<sup>1189</sup> Further, advisers typically provide information to existing investors about private fund fees and expenses in periodic financial statements, schedules, and other reports under the terms of the fund documents.<sup>1190</sup>

However, reports that are provided to investors may report only aggregated expenses, or may not provide detailed information about the calculation and implementation of any negotiated rebates, credits, or offsets.<sup>1191</sup> Investors may use the information that they receive about their

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<sup>1187</sup> *Id.*; ILPA Private Fund Advisers Data Packet, *supra* footnote 983.

<sup>1188</sup> ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983, at 16-17; ILPA Private Fund Advisers Data Packet, *supra* footnote 983, at 23.

<sup>1189</sup> *See supra* sections II.B.1, II.B.2.

<sup>1190</sup> *Id.*

<sup>1191</sup> *See supra* section II.B.

fund investments to monitor the expenses and performance from those investments. Their ability to measure and assess the impact of fees and expenses on their investment returns depends on whether, and to what extent, they are able to receive detailed disclosures regarding those fees and expenses and regarding fund performance. Some investors currently do not receive such detailed disclosures, and this reduces their ability to monitor the performance of their existing fund investment or to compare it with other prospective investments.

In other cases, adviser reliance on exemptions from specific regulatory burdens for other regulators can lead advisers to make certain quarterly disclosures. For example, while we believe that many advisers to hedge funds subject to the jurisdiction of the U.S. Commodity Futures Trading Commission (“CFTC”) rely on an exemption provided in CFTC Regulation § 4.13 from the requirement to register with CFTC as a “commodity pool operator,” some may rely on other CFTC exemptions, exclusions or relief. Specifically, we believe that some advisers registered with the CFTC may operate with respect to a fund in reliance on CFTC Regulation § 4.7, which provides certain disclosure, recordkeeping and reporting relief and to the extent that the adviser does so, the adviser would be required to, no less frequently than quarterly, prepare and distribute to pool participants statements that present, among other things, the net asset value of the exempt pool and the change in net asset value from the end of the previous reporting period.

In addition, information about advisers’ fees and about expenses is often included in advisers’ marketing documents, or included in the fund documents, yet the information may not be standardized or uniform. Many advisers to private equity funds and other illiquid funds provide prospective investors with access to a virtual data room for the fund, containing the fund’s offering documents (including categories of fees and expenses that may be charged), as

well as the adviser’s brochure and other ancillary items, such as case studies.<sup>1192</sup> These advisers meet the contractual and other needs of investors for updated information by updating the documents in the data room. Many advisers to funds that would be considered liquid funds under the rule, such as hedge funds, tend not to use data rooms. They instead take the approach of sending email or using other methods to convey updated information to investors. For instance, prior to closing on a prospective investor’s investment, some advisers send out preclosing email messages containing updated versions of these and other documents. Prospective investors at the start of the life of a fund, or at or before the time of their investment, may use this information in conducting due diligence, in deciding whether to seek to negotiate the terms of investment, and ultimately in deciding whether to invest in the adviser’s fund.

The adviser’s and related persons’ rights to compensation, which are set forth in fund documents, vary across fund types and advisers and can be difficult to quantify at the time of the initial investment. For example, advisers of private equity funds generally receive a management fee (compensating the adviser for managing the affairs of the fund) and performance-based compensation (incentivizing advisers to maximize the fund’s profits).<sup>1193</sup> Performance-based compensation arrangements in private equity funds typically require that investors recoup capital contributions plus a minimum annual return (called the “hurdle rate” or “preferred return”), but these arrangements can vary according to the waterfall arrangement used, meaning that distribution entitlements between the adviser (or its related persons) and the private

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<sup>1192</sup> To the extent that a private fund’s securities are offered pursuant to 17 CFR 230.500 through 230.508 (Regulation D of the Securities Act) and such offering is made to an investor who is not an “accredited investor” as defined therein, that investor must be provided with disclosure documents that generally contain the same type of information required to be provided in offerings under Regulation A of the Securities Act, as well as certain financial statement information. *See* 17 CFR 230.502(b). However, private funds generally do not offer interests in funds to non-accredited investors.

<sup>1193</sup> *See supra* section II.B.1.

fund investors can depend on whether the proceeds are distributed on a whole-fund (known as European-style) basis or a deal-by-deal (known as American-style) basis.<sup>1194</sup> In the whole-fund (European) case, the fund typically allocates all investment proceeds to the investors until they recoup 100% of their capital contributions attributable to both realized and unrealized investments plus their preferred return, at which point fund advisers typically begin to receive performance-based compensation.<sup>1195</sup> In the deal-by-deal (American) case (or modified versions thereof), it is common for investment proceeds from each portfolio investment to be allocated 100% to investors until investors recoup their capital contributions attributable to that specific investment, any losses from other realized investments, and their applicable preferred return, and then fund advisers can begin to receive performance-based compensation from that investment.<sup>1196</sup> Under the deal-by-deal waterfall, advisers can potentially receive performance-based compensation earlier in the life of the fund, as successful investments can deliver advisers performance-based compensation before investors have recouped their entire capital contributions to the fund.<sup>1197</sup>

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<sup>1194</sup> See, e.g., David Snow, *Private Equity: A Brief Overview*, PEI Media (2007), available at [https://www.law.du.edu/documents/registrar/adv-assign/Yoost\\_PrivateEquity%20Seminar\\_PEI%20Media's%20Private%20Equity%20-%20A%20Brief%20Overview\\_318.pdf](https://www.law.du.edu/documents/registrar/adv-assign/Yoost_PrivateEquity%20Seminar_PEI%20Media's%20Private%20Equity%20-%20A%20Brief%20Overview_318.pdf).

<sup>1195</sup> *Id.*

<sup>1196</sup> *Id.*

<sup>1197</sup> Waterfalls (especially deal-by-deal waterfalls) typically have clawback arrangements to ensure that advisers do not retain carried interest unless investors recoup their entire capital contributions on the whole fund, plus a preferred return. The result is that total distributions to investors and advisers under the two waterfalls can be equal (but may not always be), conditional on correct implementation of clawback provisions. In that case, the key difference in the two arrangements is that deal-by-deal waterfalls result in fund advisers potentially receiving their performance-based compensation faster. However, some deal-by-deal waterfalls may also require fund advisers to escrow their performance-based compensation until investors receive their total capital contributions to the fund plus their preferred return on the total capital contributions. These escrow policies can help secure funds that may need to be available in the event of a clawback. *Id.*

Management fee compensation figures and performance-based compensation figures are not widely disclosed or reported publicly,<sup>1198</sup> but the sizes of certain of these fees have been estimated in industry and academic literature. For example, one study estimated that from 2006-2015, performance-based compensation alone for private equity funds averaged \$23 billion per year.<sup>1199</sup> Private fund fees increase as assets under management increase, and the private fund industry has grown since 2015, and as a result private equity management fees and performance-based compensation fees may together currently total over \$100 billion dollars in fees per year.<sup>1200</sup> Private equity represents \$4.2 trillion of the \$11.5 trillion dollars in net assets under management by private funds,<sup>1201</sup> and so total fees across private funds may be over \$200 billion dollars in fees per year.<sup>1202</sup>

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<sup>1198</sup> Ludovic Phalipoou, *An Inconvenient Fact: Private Equity Returns & The Billionaire Factory*, Univ. of Oxford (Said Bus. Sch. Working Paper, June 10, 2020), available at <https://ssrn.com/abstract=3623820>.

<sup>1199</sup> *Id.*; see also SEC, DIV. OF INVESTMENT MGMT: ANALYTICS OFFICE, PRIVATE FUNDS STATISTICS REPORT: FOURTH CALENDAR QUARTER 2015, at 5 (July 22, 2016), available at <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2015-q4.pdf>.

<sup>1200</sup> Private equity management fees are currently estimated to typically be 1.76% and performance-based compensation is currently estimated to typically be 20.3% of private equity fund profits. See, e.g., Ashley DeLuce & Pete Keliuotis, *How to Navigate Private Equity Fees and Terms*, CALLAN'S RSCH. CAFÉ (Oct. 7, 2020), available at <https://www.callan.com/uploads/2020/12/2841fa9a3ea9dd4dddf6f4daef1ccc4/callan-institute-private-equity-fees-terms-study-webinar.pdf>. Private equity net assets under management as of the fourth quarter of 2020 were approximately \$4.2 trillion. SEC, DIV. OF INVESTMENT MGMT: ANALYTICS OFFICE, PRIVATE FUNDS STATISTICS REPORT: FOURTH CALENDAR QUARTER 2020, at 5 (Aug. 4, 2021), available at <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2020-q4.pdf>. Total fees may be estimated by multiplying management fee percentages by net assets under management, and by multiplying performance-based compensation percentages by net assets under management and again by an estimate of private equity annual returns, which may conservatively be assumed to be approximately 10%. See, e.g., Michael Cembalest, *Food Fight: An Update on Private Equity Performance vs. Public Equity Markets*, J.P. Morgan Asset and Wealth Mgmt. (June 28, 2021), available at <https://privatebank.jpmorgan.com/content/dam/jpm-wm-aem/global/pb/en/insights/eye-on-the-market/private-equity-food-fight.pdf>.

<sup>1201</sup> See Form PF Statistics Report, *supra* footnote 12.

<sup>1202</sup> For example, hedge fund management fees are currently estimated to typically be 1.4% per year and performance-based compensation is currently estimated to typically be 16.4% of hedge fund profits, approximately consistent with private equity fees. See, e.g., Leslie Picker, *Two and Twenty is Long Dead: Hedge Fund Fees Fall Further Below Onetime Industry Standard*, CNBC (June 28, 2021), available at <https://www.cnbc.com/2021/06/28/two-and-twenty-is-long-dead-hedge-fund-fees-fall-further-below-one-time-industry-standard.html> (citing HRF Microstructure Hedge Fund Industry Report Year End 2020).

In addition, advisers or their related persons may receive a monitoring fee for consulting services targeted to a specific asset or company in the fund portfolio.<sup>1203</sup> Whether they ultimately retain the monitoring fee depends, in part, on whether the fund's governing documents require the adviser to offset portfolio investment compensation against other revenue streams or otherwise provide a rebate to the fund (and so indirectly to the fund investors).<sup>1204</sup> There can be substantial variation in the fees private fund advisers charge for similar services and

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Hedge funds, as of the fourth quarter of 2020, represented another approximately \$4.7 trillion in net assets under management. *See* Form PF Statistics Report, *supra* footnote 12.

<sup>1203</sup> *See, e.g.*, Ludovic Phalippou, Christian Rauch & Marc Umber, *Private Equity Portfolio Company Fees*, 129 J. FIN. ECON. 3, 559-585 (2018).

<sup>1204</sup> *See supra* section II.B.1. There may be certain economic arrangements where only certain investors to the fund receive credits from rebates.



performances.<sup>1205</sup> Ultimately, the fund (and indirectly the investors) bears the costs relating to the operation of the fund and its portfolio investments.<sup>1206</sup>

Regarding performance disclosure, advisers typically provide information about fund performance to investors through the account statements, transaction reports, and other reports. Some advisers, primarily private equity fund advisers, also disclose information about past performance of their funds in the private placement memoranda that they provide to prospective investors.

Many standardized industry methods have emerged that private funds rely on to report returns and performance.<sup>1207</sup> However, each of these standardized industry methods has a

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<sup>1205</sup> See, e.g., Juliane Begenau & Emil Siriwardane, *How Do Private Equity Fees Vary Across Public Pensions?* (Harvard Bus. Sch. Working Paper, Jan. 2020, Revised Feb. 2021) (concluding that a sample of public pension funds investing in a sample of private equity funds would have received an average of an additional \$8.50 per \$100 invested had they received the best observed fees in the sample); Tarun Ramadorai & Michael Streatfield, *Money for Nothing? Understanding Variation in Reported Hedge Fund Fees* (Paris, Dec. 2012 Finance Meeting, EUROFIDAI-AFFI Paper, Mar. 28, 2011), available at <https://ssrn.com/abstract=1798628> (retrieved from SSRN Elsevier database) (finding that in a sample of hedge fund advisers, management fees ranging from less than 0.5% to over 2% and finding incentive fees ranging from less than 5% to over 20%, with no detectable difference in performance by funds with different management fees and only modest evidence of higher incentive fees yielding higher returns). One commenter states that “[t]he Commission is concerned” about this substantial variation in fees, and argues that we have overlooked that there are economic reasons for different fees or prices charged to investors. See AIC Comment Letter I, Appendix 1. We do not believe this argument correctly characterizes the Proposing Release or the final rules. While we agree that there are economic reasons for different fees or prices charged, in particular that charging different fees may be a plausible substitute for other more harmful types of preferential treatment, we believe that this substantial variation in fees across funds means that achieving appropriate transparency is crucial for investors. See Proposing Release, *supra* footnote 3, at 204; see also *supra* section VI.B, *infra* sections VI.D.2, VI.D.4. Another commenter stated that “[t]o support [their] assertion with respect to hedge funds, [the Commission] cites a lone study . . . . However, a meaningful assessment of price competition . . . cannot be based on unsubstantiated assertions and a lone study.” CCMR Comment Letter IV. We believe this mischaracterizes the Proposing Release. The additional statistics cited by this commenter speak to average alpha, average returns, and average risk-adjusted returns of hedge funds, among other average statistics. The Proposing Release, by contrast, discusses substantial variation across advisers in fees charged and in their performance. Additional literature cited in the commenter’s analysis states “[i]n contrast to the perception of a common 2/20 fee structure,’ there are ‘considerable cross-sectional and time series variations in hedge fund fees,’” which we also believe supports the Proposing Release’s discussion. *Id.*, see also Proposing Release, *supra* footnote 3, at 196.

<sup>1206</sup> See *supra* section II.B.1.

<sup>1207</sup> As discussed above, certain factors are currently used for determining how certain types of private funds should report performance under U.S. GAAP. See *supra* section II.B.2.

variety of benefits and drawbacks, including differences in the information they are able to capture and their susceptibility to manipulation by fund advisers.

For private equity and other funds that would be determined to be illiquid under the final rules, standardized industry methods for measuring performance must contend with the complexity of the timing of potentially illiquid investments and must also reflect the adviser's discretion in the timing of distributing proceeds to investors.

One approach that has emerged for computing returns for private equity and other funds that would be determined to be illiquid funds is the internal rate of return ("IRR").<sup>1208</sup> As discussed above, an important benefit of IRR that drives its use is that IRR can reflect the timing of cash flows more accurately than other performance measures.<sup>1209</sup> All else equal, a fund that delivers returns to its investors faster will have a higher IRR.

However, current use of IRR to measure returns has a number of drawbacks, including an upward bias in the IRR that comes from a fund's use of leverage, assumptions about the reinvestment of proceeds, and a large effect on measured IRR from cash flows that occur early in the life of the pool. For example, as discussed above, some private equity funds borrow extensively at the fund level.<sup>1210</sup> This can cause IRRs to be biased upwards. Since IRRs are based in part on the length of time between the fund calling up investor capital and the fund distributing profits, private equity funds can delay capital calls by first borrowing from fund-level subscription facilities to finance investments.<sup>1211</sup>

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<sup>1208</sup> See *supra* section II.B.2.b).

<sup>1209</sup> *Id.*

<sup>1210</sup> *Id.*

<sup>1211</sup> *Id.*

This practice has several key implications for investors. First, this practice has been used by private equity funds to artificially boost reported IRRs, but investors must pay the interest on the debt used and can potentially suffer lower total returns.<sup>1212</sup> Second, because the increases to IRR can reflect a manipulation of financing timing (and can distort total returns) rather than being a reflection of the adviser's skill and return opportunities, or even a reflection of the adviser's skill in cash flow management, the higher reported performance can distort fund performance rankings and distort future fundraising outcomes.<sup>1213</sup> Lastly, use of subscription lines to boost IRRs can artificially boost IRRs over the fund's preferred return hurdle rate, resulting in the adviser receiving carried interest compensation in a scenario where the adviser would not have received carried interest without the subscription line, and where the investor may not agree that the subscription line improved total returns and warranted a carried interest payment.<sup>1214</sup> If the use of a subscription line artificially boosts the IRR and does not actually reflect the adviser's investment skill, losses later in the fund's life may be more likely, potentially resulting in a clawback.<sup>1215</sup> While investors have grown aware of these issues, utilization of subscription lines has continued to grow, and investor industry groups continue to report challenges in achieving visibility into fund liquidity and cash management practices

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<sup>1212</sup> See, e.g., JAMES F. ALBERTUS & MATTHEW DENES, DISTORTING PRIVATE EQUITY PERFORMANCE: THE RISE OF FUND DEBT, FRANK HAWKINS KENAN INSTITUTE OF PRIVATE ENTERPRISE REPORT (June 2019), available at [https://www.kenaninstitute.unc.edu/wp-content/uploads/2019/07/DistortingPrivateEquityPerformance\\_07192019.pdf](https://www.kenaninstitute.unc.edu/wp-content/uploads/2019/07/DistortingPrivateEquityPerformance_07192019.pdf); *Recommendations Regarding Private Asset Fund Subscription Lines*, Cliffwater LLC (July 10, 2017); *Subscription Lines of Credit and Alignment of Interest*, ILPA (June 2017), available at <https://ilpa.org/wp-content/uploads/2020/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf>.

<sup>1213</sup> See, e.g., Pierre Schillinger, Reiner Braun & Jeroen Cornel, *Distortion or Cash Flow Management? Understanding Credit Facilities in Private Equity Funds* (Aug. 7, 2019), available at <https://ssrn.com/abstract=3434112>; Enhancing Transparency Around Subscription Lines of Credit, *supra* footnote 1001.

<sup>1214</sup> Subscription Lines of Credit and Alignment of Interest, *supra* footnote 1212.

<sup>1215</sup> *Id.*

around subscription lines.<sup>1216</sup> As for reinvestment assumptions, the IRR as a performance measure assumes that cash proceeds have been reinvested at the IRR over the entire investment period. For example, if a private equity or other fund determined to be illiquid reports a 50% IRR but has exited an investment and made a distribution to investors early in its life, the IRR assumes that the investors were able to reinvest their distribution again at a 50% annual return for the remainder of the life of the fund.<sup>1217</sup>

Although IRR remains one of the leading standardized methods of reporting returns at present, these and other drawbacks make IRR difficult as a singular return measure, especially for investors who likely may not understand the limitations of the IRR metric, and the differences between IRR and total return metrics used for public equity or registered investment funds.

Several other measures have emerged for measuring the performance of private equity and other funds that would be determined to be illiquid under the final rule. These measures compensate for some of the shortcomings of IRR at the cost of their own drawbacks. Multiple of invested capital (“MOIC”), used by private equity funds, is the sum of the net asset value of the investment plus all the distributions received divided by the total amount paid in. MOIC is simple to understand in that it is the ratio of value received divided by money invested, but has a key drawback that, unlike IRR, MOIC does not take into account the time value of money.<sup>1218</sup>

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<sup>1216</sup> Enhancing Transparency Around Subscription Lines of Credit, *supra* footnote 1001.

<sup>1217</sup> See, e.g., Oliver Gottschalg & Ludovic Phalippou, *The Truth About Private Equity Performance*, HARVARD BUS. REV. (Dec. 2007), available at <https://hbr.org/2007/12/the-truth-about-private-equity-performance>.

<sup>1218</sup> One commenter argues that neither IRR nor MOIC takes into account the timing of fund transactions, and provides as an example three funds with different timing of contributions and distributions but the same IRR. See XTAL Comment Letter. We disagree. The fact that it is possible to construct examples in which two funds with different timings of payments can have the same IRRs does not mean that IRR broadly fails to take into account the time value of money. Rather, this only indicates that in any such examples, the comparable funds are offering similar performances to their investors, taking the time value of money into consideration. We continue to understand that, in general, IRR takes into account the time value of money.

Another measure closely related to MOIC is the TVPI, or “total value to paid-in capital” ratio.<sup>1219</sup> When applied to an entire fund, MOIC and TVPI are similar performance metrics. However, both MOIC and TVPI have analogous measures than can be applied to just the realized and unrealized portions of a fund, and differ in their approaches to these portions of funds. For TVPI, the unrealized and realized analogues are RVPI (“residual value to paid-in capital”) and DPI (“distributions to paid-in capital”) ratios, and the denominator in both of these cases is the total called capital of the entire fund.<sup>1220</sup> For MOIC, unrealized and realized MOIC have as denominators just the portions of the called capital attributable to unrealized and realized investments in the portfolio. RVPI and DPI sum to TVPI, while unrealized MOIC and realized MOIC must be combined as a weighted average to yield total MOIC. In the staff’s experience, in the TVPI framework, substantial misvaluations applied to unrealized investments, when unrealized investments are a small portion of the fund’s portfolio, may go undetected because in that case the denominator in the RVPI will be very large compared to the size of the misevaluation. By comparison, unrealized MOIC will have as a denominator just the called capital contributed to the unrealized investments, and so the misevaluation may be easier to detect.

Another measure, Public Market Equivalent (“PME”), also used by private equity and other illiquid funds, is sometimes used to compare the performance of a fund with the performance of an index.<sup>1221</sup> The measure is an estimate of the value of fund cash flows relative

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<sup>1219</sup> See *supra* section II.B.2.b).

<sup>1220</sup> See, e.g., *Private Capital Performance Terms*, PREQIN, available at <https://www.preqin.com/academy/industry-definitions/private-capital-performance-terms-definitions>.

<sup>1221</sup> See, e.g., Robert Harris, Tim Jenkinson & Steven Kaplan, *Private Equity Performance: What Do We Know?*, 69 J. FIN. 1851 (2014), available at <https://onlinelibrary.wiley.com/doi/full/10.1111/jofi.12154>; Steven Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*,

to the value of a public market index. Relative to a given benchmark, differences in PME can indicate differences in the performance of different private fund investments. However, the computation of the PME for a fund requires the availability of information about fund cash flows including their timing and magnitude.

Regardless of the performance measure applied, another fundamental difficulty in reporting the performance of illiquid funds is accounting for differences in realized and unrealized gains. Illiquid funds generally pursue longer-term investments, and reporting of performance before the fund's exit requires estimating the unrealized value of investments.<sup>1222</sup> There are often multiple methods that may be used for valuing an unrealized illiquid investment. As discussed above, the valuations of these unrealized illiquid investments are typically determined by the adviser and, given the lack of readily available market values, can be challenging. Such methods may rely on unobservable models and other inputs.<sup>1223</sup> Because advisers are typically evaluated (and, in certain cases, compensated) based on the value of these illiquid investments, unrealized valuations are at risk of being inflated, such that fund performance may be overstated.<sup>1224</sup> Some academic studies have found broadly that private equity performance is overstated, driven in part by inflated accounting of ongoing investments.<sup>1225</sup>

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60 J. FIN. 1791 (2005), *available* <https://onlinelibrary.wiley.com/doi/full/10.1111/j.1540-6261.2005.00780.x>.

<sup>1222</sup> *See supra* section II.B.2.b).

<sup>1223</sup> *Id.*

<sup>1224</sup> *Id.*

<sup>1225</sup> *See, e.g.,* Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747-1776 (Apr. 2009).

One paper cited by commenters argues that even when advisers do manipulate their investment valuations, “investors can see through [the adviser’s] manipulation on average.”<sup>1226</sup> Brown et al. (2013) agree that there is evidence of underperforming managers inflating reported returns during times when fundraising takes place, but they also find that, on average, those managers are less likely to raise a subsequent fund.<sup>1227</sup> We disagree with the commenter’s assessment that this study indicates that investors in private funds are all equipped to protect their interests without any further regulation. The paper cited itself concedes that in its findings, unskilled investors may misallocate capital, and that it is only the more sophisticated investors who may prefer the status quo to a regime with more regulation.<sup>1228</sup> We believe the commenter’s interpretation of this paper also ignores the costs that investors must currently undertake to “see through” manipulation, even on average.

Commenters also added to this discussion that there are different methods and norms for calculating gross performance and then net performance that is net of fees and expenses. In particular, the CFA Institute described the role of GIPS standards in providing definitions and methods for calculating gross returns and net returns.<sup>1229</sup> The GIPS standards define “gross-of-fees returns” as the return on investments reduced only by trading expenses.<sup>1230</sup> GIPS states that gross-of-fees returns demonstrates the firm’s expertise in managing assets without the impact of

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<sup>1226</sup> AIC Comment Letter I; Gregory W. Brown, Oleg Gredil & Steven N. Kaplan, *Do Private Equity Funds Manipulate Reported Returns?* J. FIN. ECON., Forthcoming, Fama-Miller Working Paper (Apr. 30, 2017) (“Brown et al.”), available at <https://ssrn.com/abstract=2271690>.

<sup>1227</sup> Brown et al., *supra* footnote 1226.

<sup>1228</sup> *Id.*

<sup>1229</sup> CFA Comment Letter I; CFA Comment Letter II.

<sup>1230</sup> GIPS, *Guidance Statement on Fees* (Sept. 28, 2010), available at [http://www.gipsstandards.org/wp-content/uploads/2021/03/fees\\_gs\\_2011.pdf](http://www.gipsstandards.org/wp-content/uploads/2021/03/fees_gs_2011.pdf).

the firm’s or client’s skills in negotiating fees.<sup>1231</sup> GIPS defines “net-of-fees returns” as gross-of-fees returns reduced by management fees, including performance-based fees and carried interest.<sup>1232</sup>

The CFA Institute also acknowledged the role of the recent marketing rule in defining gross and net performance.<sup>1233</sup> The marketing rule defines gross performance as “the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser’s investment advisory services to the relevant portfolio.”<sup>1234</sup> However, the final rule also offers guidance that “the final rule does not prescribe any particular calculation of gross performance . . . Under the final rule, advisers may use the type of returns appropriate for their strategies provided that the usage does not violate the rule’s general prohibitions.”<sup>1235</sup> Thus, gross reporting under GIPS standards deducts transaction fees, but under the marketing rule may or may not, depending on the adviser’s internal calculation methodologies.

The marketing rule defines net performance as “the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser’s investment advisory services to the relevant portfolio, including, if applicable, advisory fees, advisory fees paid to underlying investment vehicles, and

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<sup>1231</sup> *Id.*

<sup>1232</sup> *Id.*

<sup>1233</sup> *See, e.g.*, CFA Comment Letter I; CFA Comment Letter II.

<sup>1234</sup> Marketing Release, *supra* footnote 127.

<sup>1235</sup> *Id.*



payments by the investment adviser for which the client or investor reimburses the investment adviser.”<sup>1236</sup> Thus, net returns under GIPS standards only deduct management fees, performance-based fees, and carried interest, but under the marketing rule all fees and expenses may be deducted, depending on the adviser’s treatment of certain fees and expenses, such as custodian fees for safekeeping funds and securities.

For illiquid funds under the final rules, standard industry methods for reporting performance do not use annual returns, because annual returns for individual years may be substantially less informative for investors. For an investor in an illiquid fund who has limited or no ability to withdraw or redeem from a fund, we understand that the investor’s primary concern is more typically measurement of the total increase in the value of its investment over the life of the illiquid fund and the average cumulative return as measured by MOIC and IRR, rather than the annual returns in any given year. Consistent with this, many commenters expressed support for the proposal’s rules that would require MOIC and IRR for private equity funds and other illiquid funds, as compared to requiring annual returns.<sup>1237</sup>

Private equity funds and other illiquid funds also must, as discussed above,<sup>1238</sup> more frequently measure performance of the fund both with respect to realized and unrealized investments. In addition to the challenges described above, the difficulty of valuing unrealized investments often contributes to what is deemed a “J-Curve” to illiquid fund performance, causing many performance metrics to report negative returns for investors in early years (as investor capital calls occur, funds deploy capital, and funds hold unrealized investments) and

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<sup>1236</sup> *Id.*

<sup>1237</sup> *See, e.g.,* OPERS Comment Letter; CFA Comment Letter II.

<sup>1238</sup> *See supra* footnote 1222 and accompanying text.

large positive returns in later years (as investments succeed and are exited, and proceeds are distributed).<sup>1239</sup> As discussed above and in the Proposing Release, these problems are exacerbated by a potential lack of reliable valuation data prior to realization of an investment, in particular when the fund primarily invests in illiquid assets.<sup>1240</sup> For investors in those funds, an annual return in the middle of the life of the fund therefore does not provide the same information as the cumulative impact of their investments since the fund's inception, as measured by MOIC and IRR.<sup>1241</sup>

Other approaches tend to be used for evaluating the performance of hedge funds and other liquid funds. In particular, investors who are determining whether and when to withdraw from or request a redemption from a liquid fund typically find annual net total returns more informative than metrics such as an IRR measured since the fund's inception, as annual net total returns allow the investor to measure whether the liquid fund's performance is likely to continue to outperform its next best investment alternative. Consistent with this, many commenters disagreed with the proposed rule requirement of annual net total returns since inception, stating that more recent returns are more relevant.<sup>1242</sup> Other methods include a fund's "alpha" and its "Sharpe ratio." A fund's alpha is its excess return over a benchmark index of comparable risk. A fund's Sharpe ratio is its excess return above the risk-free market rate divided by the investment's standard deviation of returns. Many, but not all, hedge funds disclose these and

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<sup>1239</sup> See, e.g., *J Curve*, CORP. FIN. INST. (June 28, 2023), available at <https://corporatefinanceinstitute.com/resources/economics/j-curve/>.

<sup>1240</sup> See *supra* footnote 1222 and accompanying text; see also Proposing Release, *supra* footnote 3, at 59-60.

<sup>1241</sup> Because these problems are exacerbated when the fund primarily invests in illiquid assets, as separate from when the investors' interests in the fund are illiquid, certain funds that will be defined to be liquid funds under the final rules may also rely on IRR and MOIC performance reporting today.

<sup>1242</sup> See, e.g., ATR Comment Letter; ICM Comment Letter.

other performance measures, including net returns of the fund. Many hedge fund-level performance metrics can be calculated by investors directly using data on the fund's historical returns, by either combining with publicly available benchmark index data (in the case of alpha) or by combining with an estimate of the standard deviation of the fund's returns (in the case of the Sharpe ratio). Despite these detailed methods, data in commercial databases on hedge fund performance reporting may also be biased, because hedge funds choose whether and when to make their performance results available to commercial databases.<sup>1243</sup>

Because CLOs and other SAFs primarily issue debt to investors, typically structured as notes and issued in different tranches to investors, typical fee, expense, and performance reporting practices for these funds differ from other types of funds.<sup>1244</sup> Typical reporting for SAFs is designed to provide relevant information to different debt tranches of a fund, which offer different defined returns based on different priorities of payments and different defined levels of risk associated with their notes. Because debt interests in a SAF are not structured to provide

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<sup>1243</sup> See, e.g., Philippe Jorion & Christopher Schwarz, *The Fix Is In: Properly Backing Out Backfill Bias*, 32 SOC'Y FIN. STUD. 5048-5099 (Dec. 2019); see also Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence From A Sequential Decision Model*, 107 J. FIN. ECON. 610-631 (2013). One commenter stated that "[t]he Proposed Rule also casts doubt on the reliability of public data on hedge fund performance . . . implying that these data may [] overstate fund performance. The Proposed Rule then suggests that its proposed restrictions will remedy this purported lack of price and quality competition." CCMR Comment Letter IV. We believe this mischaracterizes the Proposing Release. The discussion in the Proposing Release, and in this release, pertain to whether existing private tools are sufficient for investors seeking to evaluate the performance of hedge fund advisers and other liquid fund advisers. The paragraph cited by the commenter discusses that there are limitations to the extent to which investors may be able to conduct complete evaluations of the performance of their adviser using existing methods because, for example, public commercial databases may have biased data. We agree with the commenter that, for example, there is no literature concluding that hedge fund performance is low, and that public data on hedge fund performance indicating otherwise are not a reliable rebuttal to assertions of low hedge fund performance. See Proposing Release, *supra* footnote 3, at 208, 230. Moreover, the commenter then cites additional literature illustrating that some hedge fund advisers may understate their performance in public commercial databases, for example to prevent disclosing clues about their proprietary trading strategies. We believe this result means the literature demonstrates that there is likely variation in the bias of performance reporting by hedge fund advisers. Variation in the bias of performance reporting by advisers further limits the ability to which commercial databases today can satisfy investor needs when evaluating their advisers, as investors cannot tell the direction of bias of any given adviser in the data.

<sup>1244</sup> See *supra* section II.A.

variable investment returns like an equity interest, SAF reporting metrics prioritize measuring the likelihood of the debt investor receiving its previously agreed-upon defined return. For example, commenters stated that CLOs typically report overcollateralization ratios, examinations of the average credit rating of the portfolio, the diversity of holdings within the portfolio, and the promised yield of portfolio assets.<sup>1245</sup> Monthly reports of the portfolio holdings will also often include one or more credit ratings for each individual asset in the portfolio,<sup>1246</sup> and also often include summaries of cash flows and mark to market valuations for every asset in the portfolio.<sup>1247</sup> Finally, commenters stated that CLO managers typically earn three types of management fees, all of which are set out in the indenture and paid in accordance with the waterfall, and that a CLO's quarterly reports include the calculation of the amounts to be distributed or paid in accordance with the waterfall on the payment date.<sup>1248</sup>

While the Commission believes that many advisers currently select from these varying standardized industry methods to prepare and present performance information, the difficulty in measuring and reporting returns on a basis comparable with respect to risk, coupled with the potentially high fees and expenses associated with these funds, can present investors with difficulty in monitoring and selecting their investments. Specifically, without disclosure of detailed performance measures and accounting for the impact of risk, debt, the varying impact of realized and unrealized gains, performances across funds can be highly overstated or otherwise manipulated, and so impossible to compare.<sup>1249</sup>

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<sup>1245</sup> LSTA Comment Letter; SFA Comment Letter I; SFA Comment Letter II; SIFMA-AMG Comment Letter I; TIAA Comment Letter.

<sup>1246</sup> *Id.*

<sup>1247</sup> *Id.*

<sup>1248</sup> *Id.*

<sup>1249</sup> *See, e.g.,* Phalippou et al., *supra* footnote 1225; Cembalest, *supra* footnote 1200.

#### 4. Fund Audits, Fairness Opinions, and Valuation Opinions

Currently under the custody rule, private fund advisers may obtain financial statement audits as an alternative to the requirement of the rule that an RIA with custody of client assets obtain an annual surprise examination from an independent public accountant.<sup>1250</sup> Advisers of funds that obtain these audits, regardless of the type of fund, are thus able to provide fund investors with reasonable assurances of the accuracy and completeness of the fund's financial statements and, specifically, that the financial statements are free from material misstatements.<sup>1251</sup>

Also under the custody rule, an adviser's choice for a fund to obtain an external financial statement audit (in lieu of a surprise examination) may depend on the benefit of the audit from the adviser's perspective, including the benefit of any assurances that an audit might provide investors about the reliability of the financial statement. The adviser's choice also may depend on the cost of the audit, including fees and expenses.

Based on Form ADV data and as shown below, approximately 90% of the total number of hedge funds and private equity funds that are advised by RIAs currently undergo a financial statement audit, by a PCAOB-registered independent public accountant that is subject to regular

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<sup>1250</sup> See *supra* section II.C; rule 206(4)-2(b)(4). We note that the staff has stated that, in order to meet the requirements of rule 206(4)-2(b)(4), these financial statements must be prepared in accordance with U.S. GAAP or, for certain non-U.S. funds and non-U.S. advisers, prepared in accordance with other standards, so long as they contain information substantially similar to statements prepared in accordance with U.S. GAAP, with material differences reconciled. See SEC, *Staff Responses to Questions About the Custody Rule*, available at [https://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](https://www.sec.gov/divisions/investment/custody_faq_030510.htm).

<sup>1251</sup> See, e.g., PCAOB, *AS 2301: The Auditor's Responses to the Risks of Material Misstatement*, available at <https://pcaobus.org/oversight/standards/auditing-standards/details/AS2301>; AICPA, *AU-C Section 240: Consideration of Fraud in a Financial Statement Audit* (2021), available at <https://us.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/au-c-00240.pdf>.

inspection.<sup>1252</sup> Other types of private funds advised by RIAs undergo financial statement audits with similarly high frequency, with the exception of SAFs, of which fewer than 20% are audited according to the recent ADV data.

Figure 3:

Fund Type	Total Funds	Unaudited Funds	Unaudited Pct.	Audited Pct.
Hedge Fund	12,442	1,188	9.6%	90.4%
Liquidity Fund	88	28	31.8%	68.2%
Other Private Fund	6,201	1,282	20.7%	79.3%
Private Equity Fund	22,709	2,110	9.3%	90.7%
Real Estate Fund	4,717	756	16%	84.0%
Securitized Asset Fund	2,554	2,319	90.8%	9.20%
Venture Capital Fund	2,558	498	16.3%	83.7%
Unique Totals	51,767	8,181	15.8%	84.2%

Source: Form ADV, Schedule D, Section 7.B.(1) filed between Oct. 1, 2021, and Sept. 30, 2022.

These audits, while currently valuable to investors, do not obviate the issues with fee, expense, and performance reporting discussed above.<sup>1253</sup> First, as shown in Figure 3 above, not all funds advised by RIAs currently undergo annual financial statement audits from a PCAOB-registered and -inspected auditor. Second, statements regarding fees, expenses, and performance tend to be more frequent, and thus more timely, than audited annual financial statements. Third, there currently exists a discrepancy in reporting requirements to the Commission between

<sup>1252</sup> Rule 206(4)-2(a)(4) requires that an adviser that is registered or required to be registered under Section 203 of the Act with custody of client assets to obtain an annual surprise examination from an independent public accountant. An adviser to a pooled investment vehicle that is subject to an annual financial statement audit by a PCAOB-registered independent public accountant that is subject to regular inspection is not, however, required to obtain an annual surprise examination if the vehicle distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the pool's investors within 120 days of the end of its fiscal year. *See* rule 206(4)-2(b)(4). One commenter stated that the Proposing Release's analysis of audit frequencies did not limit analysis of current audit rates to PCAOB-registered and -inspected auditors. We agree, and also note that the Proposing Release did not limit its analysis to audits of financial statements prepared in accordance with U.S. GAAP. The analysis here is limited to PCAOB-registered and -inspected independent auditors conducting audits of financial statements prepared in accordance with U.S. GAAP, and we still find that approximately 90% of funds undergo such an audit. *See* AIMA/ACC Comment Letter.

<sup>1253</sup> *See supra* section VI.C.3.

surprise examinations and audits: Problems identified during a surprise exam must currently be reported to the Commission under the custody rule, but problems identified during an audit, even if the audit is serving as the replacement for the surprise examination under the custody rule, do not need to be reported to the Commission.<sup>1254</sup> Lastly, more frequent fee, expense, and performance disclosures can include incremental and more granular information that would be useful to investors and that would not typically be included in an annual financial statement.<sup>1255</sup>

Funds of different sizes do vary in their propensity to get audits, but audits are common for funds of all sizes. Figures 4A and 4B below show that for funds of size <\$2 million, excluding securitized asset funds, approximately 4800 out of approximately 6100 funds already get an audit from a PCAOB-registered and -inspected independent auditor, or approximately 76%. For funds of size \$2 million to \$10 million, this percentage is approximately 82%. This percentage generally increases as funds get larger, such that for funds of size >\$500 million, approximately 6400 out of approximately 7000 funds already get an audit from a PCAOB-registered and -inspected independent auditor, or approximately 91%. However, of course, because larger funds have more assets, these larger funds still represent a large volume of unaudited assets. Funds of size <\$10 million have approximately \$7.1 billion in assets not audited by a PCAOB registered and inspected independent auditor, while funds of size >\$500

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<sup>1254</sup> See 17 CFR 275; rule 206(4)-2. However, the proposal of a new rule to address how investment advisers safeguard client assets considered closing this discrepancy. See Safeguarding Release, *supra* footnote 467.

<sup>1255</sup> For example, annual financial statements may not include both gross and net IRRs and MOICs, separately for realized and unrealized investments, and with and without the impact of fund-level subscription facilities. Annual financial statements may also vary in the level of detail provided for portfolio investment-level compensation. See, e.g., *Illustrative Financial Statements: Private Equity Funds*, KPMG (Nov. 2020), available at <https://audit.kpmg.us/articles/2020/illustrative-financial-statements-2020.html>; *Illustrative Financial Statements: Hedge Funds*, KPMG (Nov. 2020), available at <https://audit.kpmg.us/articles/2020/illustrative-financial-statements-2020.html>.

million have approximately \$1.9 trillion in assets not audited by a PCAOB-registered and -inspected independent auditor.<sup>1256</sup>

Funds also vary by their fund type in their propensity to get audits. Many commenters stated that CLOs and other asset-backed securitization vehicles generally do not get such audits, in particular because audited financial statements prepared under U.S. GAAP may not be as useful for investors with debt interests in cash flow vehicles such as CLOs and other such vehicles who are primarily focused on the underlying cash flows of the fund.<sup>1257</sup> CLOs are generally captured in Form ADV data under “securitized asset funds.” The low rates of audits for securitized asset funds, as seen in Figure 3 above and Figure 4B below, is therefore likely driven by the low propensity for CLO funds and other SAFs to get audits, consistent with commenters’ statements. Some commenters further stated that CLOs and other such funds are more likely to engage independent accounting firms to perform “agreed upon procedures” on quarterly reports.<sup>1258</sup> These procedures are often related to the securitized asset fund’s cash flows and the calculations relating to a securitized asset fund portfolio’s compliance with the portfolio requirements and quality tests (such as overcollateralization, diversification, interest coverage, and other tests) set forth in the fund’s securitization transaction agreements.<sup>1259</sup> The

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<sup>1256</sup> Based on staff analysis of Form ADV Schedule D, Section 7.B.(1) data filed between Oct. 1, 2017 and Sept. 30, 2022.

<sup>1257</sup> See, e.g., Canaras Comment Letter; TIAA Comment Letter; SFA Comment Letter I; SFA Comment Letter II; LSTA Comment Letter.

<sup>1258</sup> See, e.g., Canaras Comment Letter; LSTA Comment Letter; SFA Comment Letter I; SFA Comment Letter II. As discussed above, one commenter stated that GAAP’s efforts to assign, through accruals, a period to a given expense or income may not be useful, and potentially confusing, for SAF investors because principal, interest, and expenses of administration of assets can only be paid from cash received. We note that vehicles that issue asset-backed securities are specifically excluded from other Commission rules that require issuers to provide audited GAAP financial statements, and we have stated that GAAP financial information generally does not provide useful information to investors in asset-backed securitization vehicles. See *supra* section II.A; see also SFA Comment Letter I; SFA Comment Letter II.

<sup>1259</sup> *Id.*, see also *supra* sections II.C, VI.C.1.



agreed-upon-procedures report details the results of procedures performed that provide the user of the report with information regarding these complex cash allocations and distributions, whereas a financial statement audit focuses on potential investor harm regarding whether or not the financial statements are presented fairly in accordance with applicable accounting framework.<sup>1260</sup>

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<sup>1260</sup>

*Id.*

Figure 4A:

Funds that Currently Get an Audit from a PCAOB-Registered, -Inspected, and Independent Auditor						All Funds				
	2018	2019	2020	2021	2022	2018	2019	2020	2021	2022
\$0 - \$2mil funds										
Hedge Fund	946	795	800	814	845	1,117	961	1,003	1,004	1,040
Liquidity Fund	2	1	4	3	1	7	5	7	7	4
Other Private Fund	413	388	468	433	541	613	559	648	621	740
Private Equity Fund	1,910	1,928	2,028	2,152	2,562	2,365	2,325	2,460	2,602	3,080
Real Estate Fund	388	443	395	413	482	547	597	581	690	770
Venture Capital Fund	139	156	178	211	348	184	215	249	393	501
Total (for size range, excluding securitized asset funds):	3,798	3,711	3,873	4,026	4,779	4,833	4,662	4,948	5,317	6,135
\$2mil - \$10mil funds										
Hedge Fund	872	921	852	851	880	991	1,029	985	982	1,021
Liquidity Fund	5	5	3	2	3	5	5	4	2	3
Other Private Fund	418	467	477	513	606	546	600	623	693	786
Private Equity Fund	1,863	2,007	2,156	2,385	2,741	2,133	2,278	2,512	2,807	3,231
Real Estate Fund	439	438	514	569	655	572	606	640	745	851
Venture Capital Fund	175	190	243	286	501	222	249	317	402	650
Total (for size range, excluding securitized asset funds):	3,772	4,028	4,245	4,606	5,386	4,469	4,767	5,081	5,631	6,542
\$10mil - \$500mil funds										
Hedge Fund	6,603	6,720	6,641	6,761	6,965	7,203	7,335	7,235	7,380	7,581
Liquidity Fund	18	26	20	29	33	27	36	31	41	46
Other Private Fund	2,349	2,458	2,617	2,893	3,229	2,882	2,984	3,249	3,618	3,949
Private Equity Fund	7,909	8,789	9,652	10,704	12,691	8,480	9,412	10,337	11,493	13,669
Real Estate Fund	1,726	1,902	2,049	2,197	2,419	2,000	2,170	2,288	2,425	2,651
Venture Capital Fund	530	644	751	941	1,486	572	708	836	1,074	1,665
Total (for size range, excluding securitized asset funds):	19,135	20,539	21,730	23,525	26,823	21,164	22,645	23,976	26,031	29,561
>\$500mil funds										
Hedge Fund	2,133	2,093	2,178	2,356	2,564	2,289	2,246	2,360	2,594	2,800
Liquidity Fund	23	24	29	28	23	35	36	39	41	35
Other Private Fund	428	419	464	505	543	599	576	619	674	726
Private Equity Fund	1,139	1,364	1,581	1,963	2,605	1,192	1,423	1,653	2,059	2,729
Real Estate Fund	227	256	299	325	405	247	279	327	354	445
Venture Capital Fund	44	67	86	136	223	50	73	96	148	240
Total (for size range, excluding securitized asset funds):	3,994	4,223	4,637	5,313	6,363	4,412	4,633	5,094	5,870	6,975
Total: ALL	30,699	32,501	34,485	37,470	43,351	34,878	36,707	39,099	42,849	49,213

Source: Form ADV Schedule D, Section 7.B.(1) data filed between Oct. 1st, 2017, and Sept. 30th, 2022.

The Growth in the Total Number of Audits from a PCAOB-  
Registered and -Inspected Independent Auditor

	2019	2020	2021	2022
<b>\$0 - \$2mil funds</b>				
Hedge Fund	-151	5	14	31
Liquidity Fund	-1	3	-1	-2
Other Private Fund	-25	80	-35	108
Private Equity Fund	18	100	124	410
Real Estate Fund	55	-48	18	69
Venture Capital Fund	17	22	33	137
Total (for size range, excluding securitized asset funds):	-87	162	153	753
<b>\$2mil - \$10mil funds</b>				
Hedge Fund	49	-69	-1	29
Liquidity Fund	0	-2	-1	1
Other Private Fund	49	10	36	93
Private Equity Fund	144	149	229	356
Real Estate Fund	-1	76	55	86
Venture Capital Fund	15	53	43	215
Total (for size range, excluding securitized asset funds):	256	217	361	780
<b>\$10mil - \$500mil funds</b>				
Hedge Fund	117	-79	120	204
Liquidity Fund	8	-6	9	4
Other Private Fund	109	159	276	336
Private Equity Fund	880	863	1,052	1,987
Real Estate Fund	176	147	148	222
Venture Capital Fund	114	107	190	545
Total (for size range, excluding securitized asset funds):	1,404	1,191	1,795	3,298
<b>&gt;\$500mil funds</b>				
Hedge Fund	-40	85	178	208
Liquidity Fund	1	5	-1	-5
Other Private Fund	-9	45	41	38
Private Equity Fund	225	217	382	642
Real Estate Fund	29	43	26	80
Venture Capital Fund	23	19	50	87
Total (for size range, excluding securitized asset funds):	229	414	676	1,050
<b>Total: ALL</b>	<b>1,802</b>	<b>1,984</b>	<b>2,985</b>	<b>5,881</b>

Source: Form ADV Schedule D, Section 7.B.(1) data filed between Oct. 1st, 2017, and Sept. 30th, 2022.

Figure 4B:

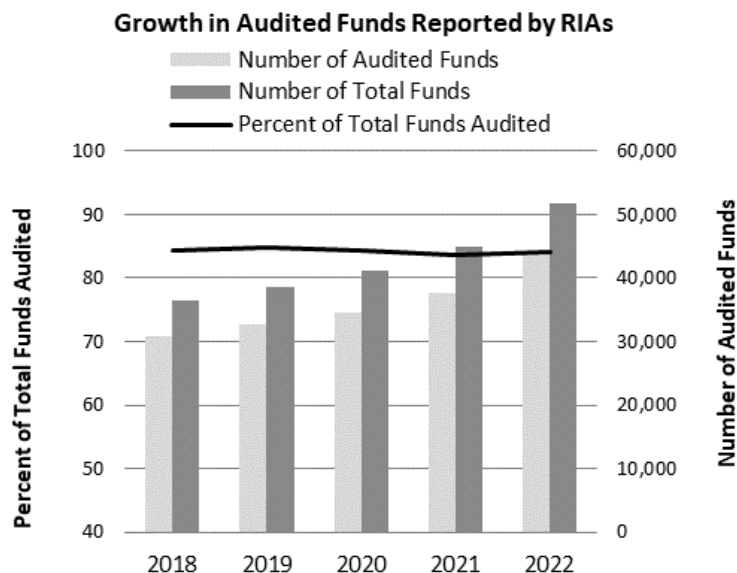
Funds that Currently Get an Audit from a PCAOB-Registered, -Inspected, and Independent Auditor						All Funds				
	2018	2019	2020	2021	2022	2018	2019	2020	2021	2022
\$0 - \$2mil funds										
Securitized Asset Fund	25	18	19	18	25	302	256	230	180	232
Total (for size range, including securitized assets):	3,823	3,729	3,892	4,044	4,804	5,135	4,918	5,178	5,497	6,367
\$2mil - \$10mil funds										
Securitized Asset Fund	12	17	15	23	18	93	95	69	73	92
Total (for size range, including securitized assets):	3,784	4,045	4,260	4,629	5,404	4,562	4,862	5,150	5,704	6,634
\$10mil - \$500mil funds										
Securitized Asset Fund	90	120	129	142	147	793	948	1,121	1,383	1,494
Total (for size range, including securitized assets):	19,225	20,659	21,859	23,667	26,970	21,957	23,593	25,097	27,414	31,055
>\$500mil funds										
Securitized Asset Fund	27	33	34	35	45	482	514	558	556	736
Total (for size range, including securitized assets):	4,021	4,256	4,671	5,348	6,408	4,894	5,147	5,652	6,426	7,711
Total: ALL	30,853	32,689	34,682	37,688	43,586	36,548	38,520	41,077	45,041	51,767

Source: Form ADV Schedule D, Section 7.B.(1) data filed between Oct. 1st, 2017, and Sept. 30th, 2022.

The Growth in the Total Number of Audits from a PCAOB- Registered and -Inspected Independent Auditor				
	2019	2020	2021	2022
\$0 - \$2mil funds				
Securitized Asset Fund	-7	1	-1	7
Total (for size range, including securitized asset funds):	-94	163	152	760
\$2mil - \$10mil funds				
Securitized Asset Fund	5	-2	8	-5
Total (for size range, including securitized asset funds):	261	215	369	775
\$10mil - \$500mil funds				
Securitized Asset Fund	30	9	13	5
Total (for size range, including securitized asset funds):	1,434	1,200	1,808	3,303
>\$500mil funds				
Securitized Asset Fund	6	1	1	10
Total (for size range, including securitized asset funds):	235	415	677	1,060
Total: ALL	1,836	1,993	3,006	5,898

Source: Form ADV Schedule D, Section 7.B.(1) data filed between Oct. 1st, 2017, and Sept. 30th, 2022.

Figure 5:



Source: Form ADV Schedule D, Section 7.B.(1) data filed between Oct. 1, 2017, and Sept. 30, 2022.

Figures 4A, 4B, and 5 also show that fund audits have also grown over time at a rate approximately consistent with the growth of the rest of private funds. Figure 5 shows that the average percentage of audited funds, across all fund sizes, has remained high at approximately 85% for the last five years. An implication of this fact is that the number of audits being added to the industry each year is not substantially larger than the number of outstanding funds not receiving audits: Figure 4B shows that approximately 8,100 funds did not get audits in 2022 from PCAOB-registered and -inspected independent auditors. Figure 4A shows that, excluding securitized asset funds, approximately 5,800 funds did not get audits in 2022 from PCAOB-registered and -inspected independent auditors. There was growth in the number of audits from

PCAOB-registered and -inspected independent private fund auditors of approximately 2,000 in 2020, approximately 3,000 in 2021, and approximately 6,000 in 2022.<sup>1261</sup>

As a final matter, several commenters state that certain funds get an audit from a Big Four firm because of their investors' demands, but none of the Big Four firms would meet the independence requirement under the proposed rules.<sup>1262</sup> These funds get an audit from a non-independent auditor, often in response to client demands for an audit, and then undergo an additional surprise exam from a PCAOB-registered and -inspected independent auditor. Another commenter stated that some funds are currently unable to get an audit from a PCAOB-registered and -inspected independent auditor, because there is a shortage of audit firms meeting those criteria for many advisers.<sup>1263</sup>

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<sup>1261</sup> *Id.* We discuss the implications of these facts for the final mandatory audit requirement below. *See infra* section VI.D.5.

<sup>1262</sup> LaSalle Comment Letter; PWC Comment Letter.

<sup>1263</sup> CFA Comment Letter I.

Figure 6:

Fund Type	Total Funds	Funds Who Get an Annual Audit That Is by a PCAOB-Registered and – Inspected Auditor But Who Is Not Independent	Get a Surprise Exam From an Independent Public Accountant	Funds Who Get an Annual Audit by an Independent Public Accountant Who is Not PCAOB-Registered and –Inspected	Get a Surprise Exam From an Independent Public Accountant
Hedge Fund	12,442	20	14	46	2
Liquidity Fund	88	0	0	0	0
Other Private Fund	6,201	175	172	16	1
Private Equity Fund	22,709	71	70	65	10
Real Estate Fund	4,717	23	5	11	3
Securitized Asset Fund	2,554	0	0	8	6
Venture Capital Fund	3,056	14	14	11	0
Unique Totals	51,767	303	275	157	22

Source: Form ADV Schedule D, Section 7.B.(1) and 9.C. data filed between Oct. 1, 2017, and Sept. 30, 2022.

Figure 6 further analyzes the funds from Figure 4 who do not get an audit by a PCAOB-registered and -inspected independent auditor. In particular, while some funds do not get audits at all, Figure 6 analyzes the funds that may get an audit, but not an audit from a PCAOB-registered and -inspected independent auditor. Figure 6 shows that less than one percent of all funds get an additional surprise exam alongside an audit from an auditor who is not independent, which indicates that no more than one percent of funds are managed by advisers who face difficulty in complying with existing audit requirements because of the independence standard. Figure 6 also shows that only a *de minimis* number of funds, namely 149 out of almost 50 thousand, excluding securitized asset funds, are managed by advisers who get an audit from an auditor who is not PCAOB-registered and -inspected.

Regarding fairness opinions, our staff has observed a recent rise in adviser-led secondary transactions where an adviser offers fund investors the choice between selling their interests in the private fund or converting or exchanging them for new interests in another vehicle advised by the adviser.<sup>1264</sup> These transactions involve direct conflicts of interest on the part of the adviser in structuring and leading these transactions because the adviser is on both sides of the transaction. In any such transaction, the adviser may face an incentive to structure the price of the transaction to be particularly beneficial to one of the vehicles, in particular by under-valuing or over-valuing the asset instead of engaging in an arms-length transaction, and so investors in one fund or the other are likely to be harmed.<sup>1265</sup> Advisers also may face an incentive to pursue these transactions even when it is not in the best interest of the fund to engage in the transaction at all. For example, it has been reported that adviser-led secondaries occur during times of stress and may be associated with an adviser who needs to restructure a portfolio investment.<sup>1266</sup> In other instances, an adviser may use an adviser-led secondary transaction to extend an investment beyond the contractually agreed upon term of the fund that holds it.<sup>1267</sup> While commenters

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<sup>1264</sup> See *supra* section II.C.

<sup>1265</sup> Unlike the case of adviser borrowing, there is a heightened risk of this conflict of interest distorting the terms or price of the transaction, and it may be difficult for disclosure practices or consent practices alone to resolve these conflicts, because in an adviser-led secondary there may be limited market-driven price discovery processes available to investors. Even where market-driven price discovery processes are available, they may be particularly subject to manipulation in the case of adviser-led secondaries. For example, if a recent sale improperly valued an asset, an adviser could be incentivized to initiate a transaction with the same valuation, which, depending on the terms of the transaction, may benefit the adviser at the expense of the investors. Similarly, if the market price of shares in a publicly traded underlying asset is volatile and drops suddenly or is depressed for an extended period of time, an adviser may be incentivized to seek to execute an adviser-led secondary with respect to such asset as soon as possible to lock in the lower price to the detriment of investors. See *supra* sections II.D, VI.C.2.

<sup>1266</sup> See, e.g., Rae Wee, *Turnover Surges As Funds Rush To Exit Private Equity Stakes*, REUTERS (Dec. 18, 2022), available at <https://www.reuters.com/business/finance/global-markets-privateequity-pix-2022-12-19/> (retrieved from Factiva database).

<sup>1267</sup> See, e.g., Madeline Shi, *Investors Up Allocation To Secondaries As GPs Seek Alternative Liquidity Sources*, PITCHBOOK (Sep. 15, 2022), available at <https://pitchbook.com/news/articles/investor-secondaries-growth-alternative-liquidity>.



stated that advisers may also pursue adviser-led secondaries for the benefit of investors,<sup>1268</sup> and we agree, the advisers' incentives to distort price or terms are present in each such transaction. Advisers also have the ability and discretion to distort price or terms in many such transactions, as many transactions in adviser-led secondaries contain level 3 or illiquid assets.<sup>1269</sup>

In part because of these risks of conflicts of interest, we understand that some, but not all, advisers obtain fairness opinions in connection with these transactions that typically address whether the price offered is fair. These fairness opinions are meant to provide investors with some third-party assurance as a means to help protect participating investors. The Commission's recently adopted amendments to Form PF require advisers to private equity funds who must file Form PF (registered advisers with at least \$150 million in private fund assets under management) to file on a quarterly basis on the occurrence of adviser-led secondary transactions.<sup>1270</sup> However, as discussed above, Form PF is not an investor-facing disclosure form. Information that private fund advisers report on Form PF is provided to regulators on a confidential basis and is nonpublic.<sup>1271</sup>

Some commenters stated that other alternatives to fairness opinions are also commonly used tools.<sup>1272</sup> A valuation opinion is a written opinion stating the value (either as a single amount or a range) of any assets being sold as part of an adviser-led secondary transaction. By contrast, a fairness opinion addresses the fairness from a financial point of view to a party paying or receiving consideration in a transaction.<sup>1273</sup> One commenter stated that the financial analyses

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<sup>1268</sup> See *supra* section II.D.

<sup>1269</sup> *Id.*

<sup>1270</sup> Form PF Release, *supra* footnote 564.

<sup>1271</sup> See *supra* section VI.C.3.

<sup>1272</sup> See, e.g., IAA Comment Letter II; Houlihan Comment Letter; Cravath Comment Letter.

<sup>1273</sup> Houlihan Comment Letter.

used to support a fairness opinion and valuation opinion are substantially similar.<sup>1274</sup> Both types of opinions generally yield implied or indicative valuation ranges.<sup>1275</sup> However, commenters stated that the costs of valuation opinions are typically lower than the costs of fairness opinions, all else equal.<sup>1276</sup> We understand this to typically be because of the extra burden of a fairness opinion in which the opinion often speaks to prices paid or received, not just to the value of the assets in the transaction.<sup>1277</sup>

We believe, based on commenter arguments and typical fairness opinion and valuation opinion practices, that to the extent that the information asymmetry between investors and advisers is concentrated in the valuation of the assets, and not other terms of the deal, a valuation opinion can alleviate this problem as effectively as a fairness opinion. We believe valuation opinions are viable options for providing price transparency to an investor, and that a valuation opinion will still provide investors with a strong basis to make an informed decision.<sup>1278</sup>

As discussed above, adviser-led secondaries may differ from other practices such as tender offers.<sup>1279</sup> Tender offers may include, for example, a transaction where the investor is not truly faced with the decision between (1) selling all or a portion of its interest and (2) converting or exchanging all or a portion of its interest.<sup>1280</sup> Tender offers may also include the case where

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<sup>1274</sup> *Id.*

<sup>1275</sup> *Id.*

<sup>1276</sup> *See, e.g.,* IAA Comment Letter II; Houlihan Comment Letter; Cravath Comment Letter.

<sup>1277</sup> Cravath Comment Letter.

<sup>1278</sup> *See supra* section II.D.2; *see also* Houlihan Comment Letter.

<sup>1279</sup> *See supra* section II.D.1.

<sup>1280</sup> *Id.*

the investor is allowed to continue to receive exposure to the asset by retaining its interest in the same fund on the same terms.<sup>1281</sup>

## **5. Books and Records**

The books and records rule includes requirements for recordkeeping to promote, and facilitate internal and external monitoring of, compliance. For example, the books and records rule requires advisers registered or required to be registered under Section 203 of the Act to make and keep true, accurate and current certain books and records relating to their investment advisory businesses, including advisory business financial and accounting records, and advertising and performance records.<sup>1282</sup> Advisers are required to maintain and preserve these records in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.<sup>1283</sup> Commenters did not provide further perspectives on the current state of books and records compliance practices.

## **6. Documentation of Annual Review Under the Compliance Rule**

Under the Advisers Act compliance rule, advisers registered or required to be registered under Section 203 of the Act must review no less frequently than annually the adequacy of their compliance policies and procedures and the effectiveness of their implementation. Currently, there is no requirement to document that review in writing.<sup>1284</sup> This rule applies to all investment advisers, not just advisers to private funds.<sup>1285</sup> We understand that many investment

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<sup>1281</sup> *Id.*

<sup>1282</sup> *See* rule 204-2 under the Advisers Act.

<sup>1283</sup> *Id.*

<sup>1284</sup> Rule 206(4)-7 under the Advisers Act.

<sup>1285</sup> *Id.*

advisers routinely make and preserve written documentation of the annual review of their compliance policies and procedures, even while the compliance rule does not require such written documentation. Many advisers retain such documentation for use in demonstrating compliance with the rule during an examination by our Division of Examinations. As discussed above, several commenters stated that written documentation of the annual review has been widely adopted as a standard practice by investment advisers.<sup>1286</sup> However, based on staff experience, we understand that not all advisers make and retain such documentation of the annual review. One commenter also described that there are a variety of ways advisers may document the annual review of their policies and procedures, including written reports, presentations, and informal compilations of notes, among other methods.<sup>1287</sup>

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<sup>1286</sup> See *supra* section III; see also SBAI Comment Letter; IAA Comment Letter II.

<sup>1287</sup> See *supra* section III; see also NSCP Comment Letter.

## **D. Benefits and Costs**

### **1. Overview**

The final rules will (a) require registered investment advisers to provide certain disclosures in quarterly statements to private fund investors, (b) require all investment advisers, including those that are not registered with the Commission, to make certain disclosures of preferential terms offered to prospective and current investors, (c) with certain exceptions, prohibit all private fund advisers, including those that are not registered with the Commission, from providing certain types of preferential treatment that the advisers reasonably expect to have a material negative effect on other investors, (d) restrict all private fund advisers, including those that are not registered with the Commission, from engaging in certain activities with respect to the private fund or any investor in that private fund, with certain exceptions for when the adviser satisfies certain disclosure requirements and, in some cases, when the adviser also satisfies certain consent requirements, (e) require a registered private fund adviser to obtain an annual financial statement audit of a private fund and, in connection with an adviser-led secondary transaction, a fairness opinion or valuation opinion from an independent opinion provider, and (f) impose compliance rule amendments and recordkeeping requirements, including certain requirements that apply to all advisers, to enhance the level of regulatory and other external monitoring of private funds and other clients.

Without Commission action, private funds and private fund advisers would have limited abilities and incentives to implement effective reforms such as those in the final rules. As discussed in the Proposing Release, private fund investments can have insufficient transparency in negotiations as well as in reporting of performance and fees/expenses, and certain sales practices, conflicts of interest, and compensation schemes are either not transparent to investors

or can be harmful and have significant negative effects on private fund returns.<sup>1288</sup> As discussed above, because of the asymmetries in investor and adviser bargaining power, investors may have limited ability to negotiate for enhanced transparency, and even new rules that mandate enhanced transparency may not give investors the ability to negotiate for safer contractual terms with respect to certain sales practices, conflicts of interest, and compensation schemes that can negatively impact investors.<sup>1289</sup>

The results are costs and risks of investor harm in financial markets, and by extension costs and risks of harm to millions of Americans through State and municipal pension plans, college and university endowments, and non-profit organizations. The relationship between fund adviser and investor can provide valuable opportunities for diversification of investments and an efficient avenue for the raising of capital, enabling economic growth that would not otherwise occur. However, the current opacity of the market can prevent even sophisticated investors from optimally obtaining certain terms of agreement from fund advisers, and this can result in investors paying excess costs, bearing excess risk, receiving limited and less reliable information about investments, and receiving contractual terms that may reduce their returns relative to what they would obtain otherwise. The final rules provide a regulatory solution that enhances the protection of investors and improves the current state of many of these problems. Moreover, the final rules do so in a way that does not deprive fund advisers of compensation for their services: Insofar as the rules shift costs and risks back onto fund advisers, the rules strengthen the incentives of advisers to manage risk in the interest of fund investors and, in doing so, does not

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<sup>1288</sup> Proposing Release, *supra* footnote 3, at 213-214.

<sup>1289</sup> See *supra* section VI.B. The lack of transparency in private fund investments can also negatively affect investors because of the lack of independent governance mechanisms, which leaves limited ability for investors to cause funds to effectively oversee and give consent to adviser practices. See *supra* sections I, VI.B, VI.C.2.

preclude fund advisers from responding by raising prices of services that are not prohibited and are transparently disclosed and, in some cases, where investor consent is obtained.

*Effects.* In analyzing the effects of the final rules, we recognize that investors may benefit from access to more useful information about the fees, expenses, and performance of private funds. They also may benefit from more intensive monitoring of funds and fund advisers by third parties, including auditors and persons who prepare assessments of secondary transactions. Finally, investors may benefit from more specific disclosure and, in some cases, consent requirements involving certain sales practices, conflicts of interest, and compensation schemes that may result in investor harm, and a restriction of certain practices where they are not specifically disclosed or, in some cases, where investor consent is not obtained. The specific provisions of the final rules will benefit investors, and by extension costs and risks of harm to millions of Americans through State and municipal pension plans, college and university endowments, and non-profit organizations, through each of these basic effects. Further effects on efficiency, competition, and capital formation are analyzed below.<sup>1290</sup>

Some commenters stated that the proposed private fund adviser rules and other recently proposed or adopted rules would have interacting effects, and that the effects should not be analyzed independently.<sup>1291</sup> The Commission acknowledges that the effects of any final rule may be impacted by recently adopted rules that precede it. Accordingly, each economic analysis in each adopting release considers an updated economic baseline that incorporates any new

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<sup>1290</sup> See *infra* section VI.E.

<sup>1291</sup> See, e.g., MFA Comment Letter II; Comment Letter of the Managed Funds Association (July 21, 2023) (“MFA Comment Letter III”); AIC Comment Letter IV. These commenters discussed generally the cumulative costs of these proposed and adopted rules, as well as possible costs of simultaneous adoption; they did not identify other specific interactions from the rules that result in benefits or costs that would not be purely additive.

regulatory requirements, including compliance costs, at the time of each adoption, and considers the incremental new benefits and incremental new costs over those already resulting from the preceding rules. That is, as stated above, the economic analysis appropriately considers existing regulatory requirements, including recently adopted rules, as part of its economic baseline against which the costs and benefits of the final rule are measured.<sup>1292</sup>

In particular, the Commission's analysis here considers three primary ways in which preceding adopted rules impact the baseline, meaning the state of the world in the absence of the final rules, and as such we believe the analysis is responsive to commenter concerns. First, as a general matter, the incremental effect of new compliance costs on advisers from the final rules can vary depending on the total amount of compliance costs already facing advisers. Whether an adviser is likely to respond to new compliance costs without exiting or without substantially passing on costs to investors depends on the adviser's profits today above existing compliance costs. Recently adopted rules impact advisers' profits, and so impact the degree to which new compliance costs may result in advisers exiting the market or in costs being passed on to investors. Second, as a related matter, if other rules have been adopted sufficiently recently, the state of the world in the absence of the final rules may specifically include the transition periods for recently adopted rules. Certain advisers may face increased costs from coming into compliance with multiple rules simultaneously. Third, to the extent recently adopted rules address matters related to those in the final rules, the benefits of the final rules may be mitigated to the extent recently adopted rules already offer certain investor protections.

Specifically, the recent amendments to Form PF may result in these three effects. First, the recent amendments to Form PF result in economic costs of new required current reporting for

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<sup>1292</sup> See *supra* section VI.C.



advisers to hedge funds and new quarterly and annual reporting for advisers to private equity funds. Second, the incremental new costs of the final private fund adviser rules may be borne, in part, at the same time as the new Form PF costs, as the effective date of the new Form PF current reporting is December 11, 2023. Third, the recently adopted Form PF amendments result in required reporting related to performance, clawbacks, and adviser-led secondaries, which may impact the benefits of the final quarterly statement rule and the final adviser-led secondaries rule.<sup>1293</sup>

While the Commission acknowledges these potential effects, we also believe we have mitigated the consequences of these overlapping costs for many advisers in the final rules by adopting a longer transition period for the private fund adviser rules, in particular for smaller advisers, as discussed further below.<sup>1294</sup> We have also responded to commenter concerns on compliance costs by offering certain disclosure-based exceptions and, in some cases, certain consent-based exceptions rather than outright prohibitions.<sup>1295</sup> Still, we understand that, at the margin, the sequencing of these rules may still result in heightened costs for certain advisers.<sup>1296</sup> To the extent heightened costs occur, these heightened costs are analyzed together with the benefits of the final rules.

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<sup>1293</sup> See *infra* sections VI.D.2, VI.D.6.

<sup>1294</sup> See *infra* section VI.E.2.

<sup>1295</sup> See *supra* section II.E.

<sup>1296</sup> The competitive effects of these heightened costs are discussed below. See *infra* section VI.E.2. The effects of these compliance costs on advisers, including their competitive effects, are difficult to quantify. Some advisers may have high profit margins but low ability or willingness to pass on new costs to funds, and so may earn lower profits but with no further effects. Other advisers may pass on some or all of the new costs to funds, and by extension their investors, reducing fund and investor returns. Still other advisers may exit the market or forgo entry. Measuring the likelihood of each of these outcomes for the purposes of quantifying effects would require individualized inquiry into the conditions and characteristics of each adviser, or would require speculative assumptions that may not be reliable.

*More useful information for investors.* Investors rely on information from fund advisers in deciding whether to continue an investment, how strictly to monitor an ongoing investment or their adviser's conduct, whether to consider switching to an alternative, whether to continue investing in subsequent funds raised by the same adviser, and how to potentially negotiate terms with their adviser on future investments.<sup>1297</sup> By requiring detailed and standardized disclosures across certain funds, the final rules will improve the usefulness of the information that current investors receive about private fund fees, expenses, and performance, and that both current and prospective investors receive about preferential terms granted to certain investors. This will enable them to evaluate more easily the performance of their private fund investments, net of fees and expenses, and to make comparisons among investments.

Finally, enhanced disclosures and, in some cases, consent requirements will help investors shape the terms of their relationship with the adviser of the private fund. As discussed above, many investors report that they accept poor terms because they do not know what is “market.”<sup>1298</sup> Many investors may benefit from the enhanced information they receive by being in a better position to negotiate the terms of their relationship with a private fund's adviser.

The rules may also improve the quality and accuracy of information received by investors through the final audit requirement, both by providing independent checks of financial statements, and by potentially improving advisers' regular performance reporting, to the extent that regular audits improve the completeness and accuracy of fund adviser valuation of investments. The final rules will lastly improve the quality and accuracy of information received

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<sup>1297</sup> For example, private equity fund agreements often allow the adviser to raise capital for new funds before the end of the fund's life, as long as all, or substantially all, of the money in prior fund has been invested. *See supra* section VI.C.2.

<sup>1298</sup> *See supra* section VI.B.

by investors through the rules providing for restrictions of certain activities unless those activities are specifically disclosed.

*Enhanced external monitoring of fund investments.* Many investors currently rely on third-party monitoring of funds for prevention and timely detection of specific harms from misappropriation, theft, or other losses to investors. This monitoring occurs through surprise exams or audits under the custody rule, as well as through other audits of fund financial statements. The final rules will expand the scope of circumstances requiring third-party monitoring, and investors will benefit to the extent that such expanded monitoring increases the speed of detection of misappropriation, theft, or other losses and so results in more timely remediation. Audits may also broadly improve the completeness and accuracy of fund performance reporting, to the extent these audits improve fund valuations of their investments. Even investors who rely on the recommendations of consultants, advisers, private banks, and other intermediaries will benefit from the final rules to the extent the recommendations by these intermediaries are also improved by the protections of expanded third-party monitoring by independent public accountants.

*Restrictions of certain activities that are contrary to public interest and to the protection of investors, with certain exceptions for disclosures and, in some cases, where investor consent is also obtained.* Certain practices represent potential conflicts of interest and sources of harm to funds and investors. As discussed above, private funds typically lack fully independent governance mechanisms more common to other markets that would help protect investors from harm in the context of the activities considered.<sup>1299</sup> While many of these conflicts of interest and sources of harm may be difficult for investors to detect or negotiate terms over, we are convinced

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<sup>1299</sup> See *supra* section VI.C.1.

by commenters that disclosure of the activities considered in the final rule, and, in some cases, investor consent, can resolve the potential investor harm. The final rule will benefit investors and serve the public interest by restricting such practices to be restricted, with certain exceptions where the adviser makes certain disclosures and, in some cases, where the adviser also obtains the required investor consent. This will further enhance investors' ability to monitor their funds through enhanced disclosures and, in some cases, consent requirements. Investors will also benefit from fund investments where advisers cease the restricted activities altogether, either because there is no exception made for disclosures or consent requirements (for example, as is the case for prohibitions on certain preferential treatment that advisers reasonably expect to have a material negative effect on other investors in the fund), or because the adviser ceases the activity voluntarily instead of making required disclosures, or in a follow-on fund where investors used the enhanced disclosure in the prior fund to negotiate the removal of the restricted activities in those future funds.<sup>1300</sup>

The direct costs of the final rules will include the costs of meeting the minimum regulatory requirements of the rules, including the costs of providing standardized disclosures, in some cases obtaining the required investor consent, and, for some advisers, refraining from restricted activities, and obtaining the required external financial statement audit and fairness opinions or valuation opinions.<sup>1301</sup> Additional costs will arise from the new compliance

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<sup>1300</sup> Investors will also have similar benefits in cases where advisers curtail the restricted activities by ceasing them in certain cases and pursuing compliance through enhanced disclosure in others.

<sup>1301</sup> One commenter, in evaluating these potential costs, states that “it is impossible or too costly to write and enforce a contract contingent on all the possible outcomes of negotiations between advisers and all the potential coinvestors.” AIC Comment Letter I, Appendix 1. We believe this argument is inapt. The proposed rules were not, and did not purport to be, an enforced contract contingent on all the possible outcomes of negotiations between advisers and investors. Neither are the final adopted rules. We agree that such a contract would be too costly to write and enforce. As discussed above, we agree with commenters who stated that policy choices benefit from taking into consideration the specific market

requirements of the final rules. For example, some advisers will update their compliance programs in response to the requirement to make and keep a record of their annual review of the program's implementation and effectiveness. Certain fund advisers may also face costs in the form of declining revenue, declining compensation to fund personnel and a potential resulting loss of employees, or losses of investor capital. Some of these costs may be passed on to investors in the form of higher fees. However, some of these costs, such as declining compensation to fund personnel, will be a transfer to investors depending on the fund's economic arrangement with the adviser. Other indirect costs of the rule may include unintended consequences to investors, such as potential losses of preferential terms for investors currently receiving them (specifically in the case of preferential terms that would not be prohibited if disclosed, but where the adviser does not want to make the required disclosures), delays in fund closing processes associated with advisers making disclosures of preferential terms.

*Scope.* There are four aspects of the scope that impact the benefits and costs of the rule. First, as discussed above, all of the elements of the final rule will in general not apply with respect to non-U.S. private funds managed by an offshore investment adviser, regardless of whether that adviser is registered.<sup>1302</sup> Second, the quarterly statements, mandatory audit, and adviser-led secondaries rules will not apply to ERAs or State-registered investment advisers.<sup>1303</sup> Third, certain elements of the rules provide for certain relief for advisers to funds of funds. For example, the quarterly statement rule requires advisers to private funds that are not funds of funds to distribute statements within 45 days after the first three fiscal quarter ends of each fiscal

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failure the policy is designed to address. We believe the final rules are consistent with this approach. *See supra* section VI.B.

<sup>1302</sup> *See supra* section II.

<sup>1303</sup> *Id.*

year (and 90 days after the end of each fiscal year), but advisers to funds of funds are allowed 75 days after the first three quarter ends of each fiscal year (and 120 days after fiscal year end).<sup>1304</sup> Investors in funds outside the scope of the rule may benefit from general pro-competitive effects of the rule,<sup>1305</sup> to the extent private funds outside the scope of the rule revise their terms to compete with funds inside the scope of the rules, and there may be risks to capital formation from the contours of the scope impacting adviser incentives,<sup>1306</sup> but investors in such funds will not otherwise be impacted. Lastly, the final rules will not apply to advisers with respect to their SAFs, such as CLOs.<sup>1307</sup>

*Legacy Status.* Commenters requested legacy status for various portions of the rule.<sup>1308</sup> We are providing for legacy status under the prohibitions aspect of the preferential treatment rule, which prohibits advisers from providing certain preferential redemption rights and information about portfolio holdings, and for the aspects of the restricted activities rule that

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<sup>1304</sup> See *supra* section II.B.3.

<sup>1305</sup> See *infra* section VI.E.2.

<sup>1306</sup> See *infra* section VI.E.3.

<sup>1307</sup> As discussed above, not all funds reported as SAFs in Form ADV will meet this definition. We recognize that certain private funds have, in recent years, made modifications to their terms and structure to facilitate insurance company investors' compliance with regulatory capital requirements to which they may be subject. These funds, which are typically structured as rated note funds, often issue both equity and debt interests to the insurance company investors, rather than only equity interests. Whether such rated note funds meet the SAF definition depends on the facts and circumstances. However, based on staff experience, the modifications to the fund's terms generally leave "debt" interests substantially equivalent in substance to equity interests, and advisers typically treat the debt investors substantially the same as the equity investors (e.g., holders of the "debt" interests have the same or substantially the same rights as the holders of the equity interests). We would not view investors that have equity-investor rights (e.g., no right to repayment following an event of default) as holding "debt" under the definition, even if fund documents refer to such persons as "debt investors" or they otherwise hold "notes." Further, we do not believe that certain rated note funds will meet the second prong of the definition (*i.e.*, a private fund whose primary purpose is to issue asset backed securities), because they generally do not issue asset-backed securities. See *supra* section II.A. This means that SAFs for the purposes of this definition are likely even more disproportionately CLOs than is indicated by the statistics in section VI.C.1.

<sup>1308</sup> See *supra* section IV.

require investor consent.<sup>1309</sup> The legacy status provisions apply to governing agreements, as specified above, that were entered into prior to the compliance date if the rule would require the parties to amend such an agreement.<sup>1310</sup> Outside of these exceptions, the benefits and costs of the rule will accrue across all private funds and advisers. This application of legacy status mean that benefits and costs of the prohibition may not accrue with respect to private funds and advisers whose agreements were entered into prior to the compliance date. In the case of advisers to evergreen private funds, where the fund agreements have no defined end of life of the fund, such preferential terms with legacy status may persevere long after the compliance date. However, those advisers will now need to compete with advisers that are subject to the final rules with respect to their newer funds. To the extent that investors prefer private funds and advisers who do not rely on such practices, then to compete to attract those investors, even some private funds with legacy status may revise their practices over time.

Below we discuss these benefits and costs in more detail and in the context of the specific elements of the final rule.

## **2. Quarterly Statements**

The final rules will require a registered investment adviser to prepare a quarterly statement for any private fund that it advises, directly or indirectly, that has at least two full fiscal quarters of operating results, and distribute the quarterly statement to the private fund's investors within 45 days after each fiscal quarter end after the first three fiscal quarter ends of each fiscal year (and 90 days after the end of each fiscal year), unless such a quarterly statement is prepared

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<sup>1309</sup> *Id.*

<sup>1310</sup> *Id.*

and distributed by another person.<sup>1311</sup> The rule provides that, to the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading, the adviser must consolidate the quarterly statement reporting to cover, as defined above, similar pools of assets.<sup>1312</sup>

We discuss the costs and benefits of these requirements below. It is generally difficult to quantify these economic effects with meaningful precision, for a number of reasons. For example, there is a lack of quantitative data on the extent to which advisers currently provide information that will be required to be provided under the final rule to investors. Even if these data existed, it would be difficult to quantify how receiving such information from advisers may change investor behavior. In addition, the benefit from the requirement to provide the mandated performance disclosures will depend on the extent to which investors already receive the mandated information in a clear, concise, and comparable manner. As discussed above, however, we believe that the format and scope of these disclosures vary across advisers and private funds, with some disclosures providing limited information while others are more detailed and complex.<sup>1313</sup> As a result, parts of the discussion below are qualitative in nature.<sup>1314</sup>

#### *Quarterly Statement – Fee and Expense Disclosure*

The final rule will require an investment adviser that is registered or required to be registered and that provides investment advice to a private fund to provide each of the private

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<sup>1311</sup> See *supra* section II.B.

<sup>1312</sup> See *supra* section II.B.4.

<sup>1313</sup> See *supra* section VI.C.3.

<sup>1314</sup> Some commenters criticized this approach to the costs and benefits discussion. These commenters state that the analysis is deficient, not appropriate, and sparse, among other criticisms. See, e.g., AIC Comment Letter I, Appendix 1; AIMA/ACC Comment Letter. We continue to believe that the economic analysis is mindful of the costs imposed by, and the benefits obtained from, the final rules, and have considered, in addition to the protection of investors, whether the action would promote efficiency, competition, and



fund investors with a quarterly statement containing certain information regarding fees and expenses, including fees and expenses paid by underlying portfolio investments to the adviser or its related persons. The quarterly statement will include a table detailing all adviser compensation to advisers and related persons, fund expenses, and the amount of offsets or rebates carried forward to reduce future payments or allocations to the adviser or its related persons.<sup>1315</sup> Further, the quarterly statement will include a table detailing portfolio investment compensation.<sup>1316</sup> The quarterly statement rule will require each quarterly statement to be distributed within 45 days after each the first, second, and third fiscal quarter ends and 90 days after the final fiscal quarter end.<sup>1317</sup> Statements must include clear and prominent, plain English disclosures regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated, and include cross-references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.<sup>1318</sup> If the private fund is a fund of funds, then a quarterly statement must be distributed within 75 days after the first, second, and third fiscal quarter ends and 120 days after the final fiscal quarter end.<sup>1319</sup><sup>1320</sup>

### *Benefits*

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capital formation. The following analysis considers, in detail, the potential economic effects that may result from this final rulemaking, including the benefits and costs to market participants as well as the broader implications of the final rules for efficiency, competition, and capital formation. One commenter was broadly supportive of the depth and scope of the economic analysis offered in the Proposing Release. *See* Better Markets Comment Letter.

<sup>1315</sup> *See supra* section II.B.1.b).

<sup>1316</sup> *See supra* section II.B.1.b).

<sup>1317</sup> *See supra* section II.B.1.

<sup>1318</sup> *Id.*

<sup>1319</sup> *Id.*

<sup>1320</sup> *Id.*

The effect of this requirement to provide a standardized minimum amount of information in an easily understandable format will be to lower the cost to investors of monitoring fund fees and expenses, lower the cost to investors of monitoring any conflicting arrangements, improve the ability of investors to negotiate terms related to the governance of the fund, and improve the ability of investors to evaluate the value of services provided by the adviser and other service providers to the fund. The lack of legacy status for this rule provision means that these benefits will accrue across all private funds and advisers.

We continue to believe that the final rules will achieve the benefits as stated in the Proposing Release. For example, investors could more easily compare actual investment returns to the projections they received prior to investing. As discussed above, any waterfall arrangements governing fund adviser compensation may be complex and opaque.<sup>1321</sup> As a result, investor returns from a fund may be affected by whether investors are able to follow, and verify, payments that the fund is making to investors and to the adviser in the form of performance-based compensation, as these payments are often only made after investors have recouped the applicable amount of capital contributions and received any applicable preferred returns from the fund. This information may also help investors evaluate whether they are entitled to the benefit of a clawback. For example, for deal-by-deal waterfalls, where advisers may be more likely to be subject to a clawback,<sup>1322</sup> even sophisticated investors have reported difficulty in measuring and evaluating compensation made to fund advisers and determining if adviser fees comply with the fund's governing agreements.<sup>1323</sup> Any such investors would benefit

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<sup>1321</sup> See *supra* section VI.C.3.

<sup>1322</sup> *Id.*

<sup>1323</sup> See *supra* section II.B.1.

to the extent that the required disclosures under the final rules address these difficulties. Fee and compensation arrangements for other types of private funds also vary in their approach and complexity, and investors in all types of private funds will therefore benefit from the standardization under the final rules.<sup>1324</sup>

With respect to hedge funds, as discussed above, one commenter criticized the Proposing Release’s statement that there can be substantial variation in the fees private fund advisers charge for similar services and performances.<sup>1325</sup> We believe this mischaracterizes the potential benefits of the proposal and of the final rules. First, the additional statistics cited by this commenter speak to average alpha, average returns, and average risk-adjusted returns of hedge funds, among other average statistics.<sup>1326</sup> The Proposing Release, by contrast, discusses substantial variation across advisers in fees charged and in their performance. Additional literature cited in the commenter’s analysis states “[i]n contrast to the perception of a common 2/20 fee structure,’ there are ‘considerable cross-sectional and time series variations in hedge fund fees,’” which we also believe supports the Proposing Release’s discussion.<sup>1327</sup>

Investors may also find it easier to compare alternative funds to other investments. As a result, some investors may reallocate their capital among competing fund investments and, in doing so, achieve a better match between their choice of private fund and their preferences over private fund terms, investment strategies, and investment outcomes. For example, investors may discover differences in the cost of compensating advisers across funds that lead them to move

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<sup>1324</sup> See *supra* sections II.B, VI.C.3. In particular, commenters stated that the proposed disclosure requirements were appropriate for investors to all types of private funds. See, e.g., CFA Comment Letter II.

<sup>1325</sup> See *supra* section VI.C.3; see also CCMR Comment Letter IV.

<sup>1326</sup> *Id.*

<sup>1327</sup> *Id.* See also Proposing Release, *supra* footnote 3, at 218.

their assets into funds (if able to do so) with less costly advisers or other service providers.

Investors may also have an improved ability to negotiate expenses and other arrangements in any subsequent private funds raised by the same adviser. Investors may therefore face lower overall costs of investing in private funds as a benefit of the standardization. In addition, an investor may more easily detect errors by reading the adviser's disclosure of any offsets or rebates carried forward to subsequent periods that would reduce future adviser compensation. This information will make it easier for investors to understand whether they are entitled to additional reductions in future periods.

Because the rule requires disclosures at both the private-fund level and the portfolio level, investors can more easily evaluate the aggregate fees and expenses of the fund, including the impact of individual portfolio investments. The private fund level information will allow investors to more easily evaluate their fund fees and expenses relative to the fund governing documents, evaluate the performance of the fund investment net of fees and expenses, and evaluate whether they want to pursue further investments with the same adviser or explore other potential investments. The portfolio investment level information will allow investors to evaluate the fees and costs of the fund more easily in relation to the adviser's compensation and ownership of the portfolio investments of the fund. For example, investors will be able to evaluate more easily whether any portfolio investments are providing compensation that could entitle investors to a rebate or offset of the fees they owe to the fund adviser. This information will also allow investors to compare the adviser's compensation from the fund's portfolio investments relative to the performance of the fund and relative to the performance of other investments available to the investor. To the extent that this heightened transparency encourages advisers to make more substantial disclosures to prospective investors, investors may also be

able to obtain more detailed fee and expense and performance data for other prospective fund investments. As a result of these required disclosures, investor choices over private funds may more closely match investor preferences over private fund terms, investment strategies, and investment outcomes.

The magnitude of the effect depends on the extent to which investors do not currently have access to the information that will be reported in the quarterly statement in an easily understandable format and will use the information once provided. Several commenters argue that advisers are already providing investors with sufficient disclosures on all items described in the required quarterly statements, or that investors rarely ask for more information than is provided by current practices.<sup>1328</sup> One commenter stated that the increasing demand for private equity advisory services suggests that investors are satisfied with the level of disclosure provided to them.<sup>1329</sup>

However, many other commenters broadly supported these categories of benefits, both from the required quarterly statements in general and from the final rule's overall enhancement of disclosures.<sup>1330</sup> Other commenters specifically supported the general enhancement of fee and expense disclosure.<sup>1331</sup> Two commenters supported enhanced disclosure of adviser compensation.<sup>1332</sup>

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<sup>1328</sup> See, e.g., NYC Bar Comment Letter II; AIMA/ACC Comment Letter; Dechert Comment Letter; AIC Comment Letter I; ICM Comment Letter; Schulte Comment Letter.

<sup>1329</sup> AIC Comment Letter I, Appendix 1.

<sup>1330</sup> See, e.g., InvestX Comment Letter; NEA and AFT Comment Letter; United For Respect Comment Letter I; Public Citizen Comment Letter; Better Markets Comment Letter.

<sup>1331</sup> See, e.g., Segal Marco Comment Letter; Seattle Retirement System Comment Letter; Morningstar Comment Letter; CFA Comment Letter II.

<sup>1332</sup> Morningstar Comment Letter; CFA Comment Letter II.

Moreover, as discussed above, industry literature provides a countervailing view to these industry commenters, at least for private equity investors.<sup>1333</sup> In 2021, 59% of private equity LPs in a survey reported receiving ILPA’s reporting template more than half the time, indicating that LPs must continue to use their negotiating resources to receive the template, and many investors do not receive reporting consistent with the template.<sup>1334</sup> In a more recent survey, 56% of private equity investor respondents indicated that information transparency requests granted to one investor are generally not granted to all investors, and 75% find that an adviser’s agreement to report fees and expenses consistent with the ILPA reporting template was made through the side letter, or informally, and not reflected in the fund documents presented to all investors.<sup>1335</sup>

Because we have not applied the rules to advisers with respect to their CLOs and other SAFs,<sup>1336</sup> no benefits will accrue to investors in those funds. However, we understand from commenters and from staff understanding that these forgone benefits associated with fee and expense reporting, relative to the proposal, are minimal, based on existing practices for fee and expense reporting associated with CLOs and other SAFs, and based on the fee, expense, and performance reporting needs of CLO investors and other SAF investors.<sup>1337</sup> This is because debt interests in a SAF are not structured to provide variable investment returns like an equity interests, and so SAF reporting metrics that are of value to SAF investors should prioritize measuring the likelihood of the debt investor receiving its previously agreed-upon defined

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<sup>1333</sup> See *supra* section VI.C.3.

<sup>1334</sup> See *supra* section VI.C.3; see also ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983, at 17.

<sup>1335</sup> See *supra* section VI.C.3; see also ILPA Comment Letter II; The Future of Private Equity Regulation, *supra* footnote 983; ILPA Private Fund Advisers Data Packet, *supra* footnote 983.

<sup>1336</sup> See *supra* section II.A.

<sup>1337</sup> See *supra* sections II.A, VI.C.3.

return.<sup>1338</sup> While this means that the reporting metrics required by the final rules could be of value to investors in the equity tranche of a CLO or other SAF, equity tranches are typically only a small portion of the CLO, on the order of 10%, and a portion of the holders of the equity tranche of CLOs and other SAFs consists of the adviser and its related persons, further reducing the forgone benefits from not applying the rules to advisers in those cases.<sup>1339</sup>

Benefits of the required disclosures may also be slightly reduced for investors in funds of funds, because (1) investors in funds of funds will generally receive the information in a less timely manner as compared to other types of funds, and because (2) certain fund of funds advisers may lack information or may not be given information in respect of underlying entities, and depending on a private fund's underlying investment structure, a fund of funds adviser may have to rely on good faith belief to determine which entity or entities constitute a portfolio investment under the rule.<sup>1340</sup> However, investors in funds of funds will benefit from their fund managers receiving quarterly statements from the underlying fund advisers, allowing the fund of fund manager to better monitor and negotiate with unaffiliated advisers to underlying funds.

Lastly, while many advisers not required to send quarterly statements choose to do so anyway, existing quarterly statements are not standardized across advisers and may vary in their level of detail. For example, we understand that many private equity fund governing agreements are broad in their characterization of the types of expenses that may be charged to portfolio

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<sup>1338</sup> *Id.*

<sup>1339</sup> *Id.*

<sup>1340</sup> *See supra* section II.B.1.

investments and that investors receive reports of fund expenses that are aggregated to a level that makes it difficult for investors to verify that the individual charges to the fund are justified.<sup>1341</sup>

As a result of this variation across advisers in quarterly statement practices, the final rules will have two key interactions with Form PF reporting that affect the benefits of the final rules. First, Form PF requires information pertaining to fees and expenses (namely gross performance and then net performance after management fees, incentive fees, and allocations). The Commission may rely on data in Form PF to pursue potential outreach, examinations, or investigations, in response to any potential harm to investors associated with fees and expenses being charged to investors.<sup>1342</sup> Therefore, any investor protection benefits of the final rules may be mitigated to the extent that Form PF is already a sufficient tool for investor protection purposes on matters related to fees and expenses.<sup>1343</sup> However, we do not believe the benefits will be meaningfully mitigated for two reasons. First, the information Form PF collects on fees and expenses is limited to performance net of management fees and performance fees, which may be compared to gross performance to infer the value of those fees.<sup>1344</sup> Second, Form PF is not an investor-facing disclosure form. Information that private fund advisers report on Form PF is provided to regulators on a confidential basis and is nonpublic.<sup>1345</sup> The benefits from the final rules accrue substantially from investors receiving enhanced and standardized information.

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<sup>1341</sup> See, e.g., StepStone, *Uncovering the Costs and Benefits of Private Equity* (Apr. 2016), available at [https://www.stepstonegroup.com/wp-content/uploads/2021/07/StepStone\\_Uncovering\\_the\\_Costs\\_and\\_Benefits\\_of\\_PE.pdf](https://www.stepstonegroup.com/wp-content/uploads/2021/07/StepStone_Uncovering_the_Costs_and_Benefits_of_PE.pdf).

<sup>1342</sup> Form PF Release, *supra* footnote 564.

<sup>1343</sup> *Id.*

<sup>1344</sup> *Id.*

<sup>1345</sup> See *supra* section VI.C.3.



Second, the final rules may enhance the benefits from Form PF reporting, because Form PF reporting often only requires reporting on the basis of how advisers report information to investors.<sup>1346</sup> Standardizing practices of disclosures of fee and expense reporting may improve data collected by Form PF, including data collected by the recently adopted Form PF current reporting regime (after the new current reporting regime's effective date of 180 days after publication in the Federal Register), improving Form PF's systemic risk assessment and investor protection benefits.

As discussed above, we believe that some investors in hedge funds whose advisers are operating in reliance on the exemption set forth in CFTC Regulation 4.7 may currently receive quarterly statements that present, among other things, the net asset value of the exempt pool and the change in net asset value from the end of the previous reporting period.<sup>1347</sup> While this could have the effect of mitigating some of the benefits of the rule if this information is already provided, and one commenter suggested excluding investors in private funds for which the adviser is a registered commodity pool operator or is relying on the exemption under CFTC Regulation 4.7,<sup>1348</sup> we do not believe that reports provided to investors pursuant to CFTC Regulation § 4.7 require all of the information as required under the final rule.

The magnitude of the effect also depends on how investors will use the fee and expense information in the quarterly statement. In addition, reports of fund expenses often do not include data about payments at the level of portfolio investments, or about how offsets are calculated,

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<sup>1346</sup> See *supra* section VI.C.3.

<sup>1347</sup> See *supra* section VI.C.3.

<sup>1348</sup> AIMA/ACC Comment Letter.

allocated and applied. Lack of disclosure has been at issue in enforcement actions against fund managers.<sup>1349</sup>

### *Costs*

The cost of the changes in fee and expense disclosure will include the cost of compliance by the adviser. For advisers that currently maintain the records needed to generate the required information, the cost of complying with this new disclosure requirement will be limited to the costs of compiling, preparing, and distributing the information for use by investors and the cost of distributing the information to investors. We expect these costs will generally be ongoing costs. For advisers who already both maintain the records needed to generate the required information and make the required disclosures, the costs will be even more limited. We anticipate this may be the case for many private fund advisers, as we believe many private fund advisers already maintain and disclose similar information to what is required by the rule.<sup>1350</sup>

Costs of delivery may be mitigated by the fact that the final rule generally allows for distribution of statements via a data room, if the adviser notifies investors when the quarterly statements are uploaded to the data room within the applicable time period under the rule and ensures that investors have access to the quarterly statement therein.<sup>1351</sup> Because certain of the rules will not apply to SAF advisers, there will be no costs for SAF advisers or their investors.<sup>1352</sup>

Other costs may include advisers needing to make determinations about what must be included on their fee and expense quarterly statements. In particular, even though portfolio

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<sup>1349</sup> See *supra* footnotes 217-222 (with accompanying text).

<sup>1350</sup> See *supra* section VI.C.3.

<sup>1351</sup> See *supra* section II.B.3.

<sup>1352</sup> See *supra* section II.A.

investments of certain private funds may not pay or allocate portfolio investment compensation to an adviser or its related persons, advisers to those funds may still have costs associated with reviewing payments and allocations made by their portfolio investments to determine whether they must provide the required portfolio investment compensation disclosures under the final rule.<sup>1353</sup>

Advisers will also incur costs associated with determining and verifying that the required disclosures comply with the format requirements under the final rule, including demands on personnel time required to verify that disclosures are made in plain English regarding the manner in which calculations are made and to verify that disclosures include cross-references to the sections of the private fund's organizational and offering documents. This also includes demands on personnel time to verify that the information required to be provided in tabular format is distributed with the correct presentation. Advisers may also choose to undertake additional costs of ensuring that all information in the quarterly statements is drafted consistently with the information in fund offering documents, to avoid inconsistent interpretations across fund documents and resulting confusion for investors. Many of these costs we would expect would be borne more heavily in the initial compliance phases of the rule and would wane on an

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<sup>1353</sup> See *supra* section II.B.1.b).

ongoing basis.<sup>1354</sup> The lack of legacy status for this rule provision means that these costs will be borne across all private fund advisers and potentially passed through to the funds they advise.<sup>1355</sup>

Some commenters emphasized the potential costs of the required quarterly statements, and that these costs would be likely to be borne by the fund and thus investors instead of by advisers.<sup>1356</sup> Comments also stated that the reporting requirement would be excessively burdensome where the fund has a bespoke expense arrangement.<sup>1357</sup> Other commenters stated that the quarterly statement requirements would be overly burdensome for smaller or emerging advisers.<sup>1358</sup>

Some commenters lastly expressed concerns over unintended consequences from the rule from changes in adviser behavior in response to the rule. For example, some commenters stated that, with a required framework in place governing fund expense reporting, investors would face difficulties in negotiating for any reporting not specified in the final rules.<sup>1359</sup> While at the

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<sup>1354</sup> One commenter quantified all of the costs of the rule over a 20-year horizon, assuming constant costs over time but applying a discount rate to costs in the future. *See* LSTA Comment Letter, Exhibit C. However, we believe forecasts of costs over such a horizon face substantial difficulties in reliably taking into account changes in technology over time, changes in market practices, changes in asset allocations between private funds and other asset allocations, or changes in the regulatory landscape. Doing so requires sophisticated econometric modeling, with many assumptions beyond the use of a discount rate, and long-horizon forecasting often cannot be done reliably. *See, e.g.,* Kenichiro McAlinn & Mike West, *Dynamic Bayesian Predictive Synthesis in Time Series Forecasting*, 210 J. ECONOMETRICS 155-169 (May 2019) (“However, forecasting over longer horizons is typically more difficult than over shorter horizons, and models calibrated on the short-term basis can often be quite poor in the longer-term.”). As such, we do not incorporate forecasts of total costs over long horizons in our quantification of costs here or for other categories of costs.

<sup>1355</sup> There do not exist reliable data for quantifying what percentage of private fund advisers today engage in this activity or the other restricted activities. For the purposes of quantifying costs, including aggregate costs, we have applied the estimated costs per adviser to all advisers in the scope of the rule, as detailed in section VII.

<sup>1356</sup> *See, e.g.,* Alumni Ventures Comment Letter; Segal Marco Comment Letter; Roubaix Comment Letter; ATR Comment Letter; AIC Comment Letter I.

<sup>1357</sup> Alumni Ventures Comment Letter; ATR Comment Letter.

<sup>1358</sup> AIC Comment Letter I; SBAI Comment Letter. We discuss the impact of the final rules on smaller or emerging advisers more generally below. *See infra* section VI.E.

<sup>1359</sup> *See, e.g.,* PIFF Comment Letter; NYC Comptroller Comment Letter.

margin this may occur, we believe the final rules and this release appropriately leave investors and advisers free to negotiate any fee and expense reporting terms not specified in the final rules (though any additional reporting must still comply with other regulations, such as the final marketing rule when applicable).<sup>1360</sup> Similarly, one commenter stated that disclosing sub-adviser fees separately could disincentivize sub-advisers from offering discounted or reduced fees to private funds.<sup>1361</sup> As discussed above, we believe the final rules are designed to mitigate burden where possible and continue to facilitate competition and facilitate flexible negotiations between private fund parties.<sup>1362</sup>

Some of these costs of compliance could be reduced by the rule provision providing that, to the extent doing so would provide more meaningful information and not be misleading, advisers must consolidate the quarterly statement reporting to cover similar pools of assets, avoiding duplicative costs across multiple statements. However, in other cases the rule provision requiring consolidation may further increase the costs of compliance with the rules, not decrease the costs of compliance. For example, in the case where a private fund adviser is preparing quarterly statements for investors in a feeder fund and is consolidating statements between a master fund and its feeder funds, the consolidation may require the adviser to calculate the feeder fund's proportionate interest in the master fund on a consolidated basis. The additional costs of these calculations of proportionate interest in the master fund, to the extent the adviser does not already undertake this practice, may offset any reduced costs the adviser receives from not being

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<sup>1360</sup> See *supra* section II.B.1.

<sup>1361</sup> See AIMA/ACC Comment Letter.

<sup>1362</sup> See *supra* section VI.B.

required to undertake duplicative costs across multiple statements. Commenters did not offer any opinion as to which of these two scenarios is generally more likely to be the case.

Advisers to funds of funds may face certain additional costs associated with needing to determine whether an entity paying itself, or a related person, is a portfolio investment of the fund of funds under the final rule.<sup>1363</sup> We understand there are means available to funds of funds to mitigate these costs, such as being able to ask any such payor whether certain underlying funds hold an investment in the payor, or requesting a list of investments from underlying funds to determine whether any of those underlying portfolio investments have a business relationship with the adviser or its related persons.<sup>1364</sup> However, at the margin, there may be such increased costs, in particular in the case where certain fund of funds advisers may lack information or may not be given information in respect of underlying entities.<sup>1365</sup>

There are other aspects of the rule that will impose costs. In particular, some advisers may choose to update their systems and internal processes and procedures for tracking fee and expense information to better respond to this disclosure requirement. The costs of those improvements would be an indirect cost of the rule, to the extent they would not occur otherwise, and they are likely to be higher initially than they would be on an ongoing basis.

*Preparation and distribution of Quarterly Statements.* As discussed below, for purposes of the PRA, we anticipate that the compliance costs associated with preparation and distribution of quarterly statements (including the preparation and distribution of fee and expense disclosure, as well as the performance disclosure discussed below) will include an aggregate annual internal

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<sup>1363</sup> See *supra* section II.B.1.b).

<sup>1364</sup> *Id.*

<sup>1365</sup> *Id.*

cost of \$339,493,120 and an aggregate annual external cost of \$148,229,760, or a total cost of \$487,722,880 annually.<sup>1366</sup> For costs associated with potential upgrades to fee tracking and expense information systems, funds are likely to vary in the intensity of their upgrades, because for example some advisers may not pursue any system upgrades at all, and moreover the costs may be pursued or amortized over different periods of time. Advisers are similarly likely to vary in their choices of whether to invest in increasing the quality of their services. For both of these categories of costs, the data do not exist to estimate how funds or investors may respond to the reporting requirements, and so the costs may not be practically quantified.

Under the final rule, these compliance costs may be borne by advisers and, where permissible, could be imposed on funds and therefore indirectly passed on to investors. For example, under current practice, advisers to private funds generally charge disclosure and reporting costs to the funds, so that those costs are ultimately paid by the fund investors. Also, currently, to the extent advisers use service providers to assist with preparing statements (*e.g.*, fund administrators), those costs often are borne by the fund (and thus indirectly investors). We expect similar arrangements may be made going forward to comply with the final rule, with disclosure where required. Advisers could alternatively attempt to introduce substitute charges

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<sup>1366</sup> We have adjusted the estimates from the proposal to reflect that the five private fund rules will not apply to SAF advisers regarding SAFs they advise. *See infra* section VII.B. As explained in that section, this estimated annual cost is the sum of the estimated recurring cost of the proposed rule in addition to the estimated initial cost annualized over the first three years. One commenter broadly criticized the hours estimates underlying these cost estimates as unsupported, arbitrary, and possibly underestimated, further stating that none of the calculations rely on survey data or wage and hour studies. *See* AIC Comment Letter I, Appendix 1. We disagree. These cost estimates are based on industry survey data on wages, and we have stated the assumptions underlying the number of hours. *See infra* section VII.B. To reflect commenter concerns that quantified costs of the proposal were potentially understated, and recognizing certain changes from the proposal, we are revising the estimates upwards as reflected here and in section VII.B. For example, to address the commenter's contention that we underestimated the burdens generally, and recognizing the changes from the proposal, we are revising the internal initial burden for the preparation of the quarterly statement estimate upwards to 12 hours. We believe this is appropriate because advisers will likely need to develop, or work with service providers to develop, new systems to collect and prepare the statements.

(for example, increased management fees) in order to cover the costs of compliance with the rule, and their ability to do so may depend on the willingness of investors to incur those substitute charges.

Further, to the extent that the additional standardization and comparability of the information in the required disclosures makes it more difficult to charge fees higher than those charged for similar adviser services or otherwise to continue current levels and structures of fees and expenses, the final rules may reduce revenues for some advisers and their related persons. These advisers may respond by reducing their fees or by differentiating their services from those provided by other advisers, including by, for example, increasing the quality of their services in a manner that could attract additional capital to funds they advise. To the extent these reduced revenues result in reduced compensation for some advisers and their related persons, those entities may become less competitive as employers. However, this cost may be mitigated to the extent that some advisers attract new capital under the final rules, and so those advisers and their related persons may become more competitive as employers.

#### *Quarterly statement – Performance Disclosure*

Advisers will also be required to include standardized fund performance information in each quarterly statement provided to fund investors. Specifically, the final rules will require an adviser to a fund considered a liquid fund under the final rule to disclose the fund's annual net total returns for each fiscal year for the prior year, prior five-year period, and prior 10-year period or since inception (whichever is shorter) and the cumulative result for the year as of the most recent quarter.<sup>1367</sup> For illiquid funds, the final rule will require an adviser to show the internal rate of return (IRR) and multiple of invested capital (MOIC) (each, on a gross and net

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<sup>1367</sup> See *supra* section II.B.2.a).



basis), the gross IRR and the gross MOIC for the unrealized and realized portions of the portfolio (each shown separately), and a statement of contributions and distributions.<sup>1368</sup> Performance reporting, save for the statement of contributions and distributions, must be computed with and without the effect of any fund level subscription facilities.<sup>1369</sup> The statement of contributions and distributions must provide certain cash flow information for each fund.<sup>1370</sup> Further, advisers must include clear and prominent plain English disclosure of the criteria used and assumptions made in calculating the performance.<sup>1371</sup>

### *Benefits*

As a result of these performance disclosures, some investors will find it easier to obtain and use information about the performance of their private fund investments. They may, for example, find it easier to monitor the performance of their investments and compare the performance of the private funds in their portfolios to each other and to other investments.<sup>1372</sup> In addition, they may use the information as a basis for updating their choices between different private funds or between private fund and other investments. In doing so, they may achieve a better alignment between their investment choices and preferences. Cash flow information will be provided in a form that allows investors to compare the performance of the fund (or a fund investment) with the performance of other investments, such as by computing PME or other metrics. The lack of legacy status for this rule provision means that these benefits will accrue across all private funds and advisers.

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<sup>1368</sup> See *supra* section II.B.2.b).

<sup>1369</sup> *Id.*

<sup>1370</sup> *Id.*

<sup>1371</sup> See *supra* section II.B.2.c).

<sup>1372</sup> *Id.*; see also Brown et al., *supra* footnote 1226.

We understand that some investors receive the required performance information under the baseline, independently of the final rule. For example, some investors receive performance disclosures from advisers on a tailored basis. As noted above, many commenters stated, generally, that advisers are already providing investors with sufficient disclosures on all items described in the required quarterly statements.<sup>1373</sup> Another adviser commented that it finds investors rarely express that they want more information regarding historical performance of a fund.<sup>1374</sup> Other commenters stated that the existence of a variety of market practices reflects differing desires by investors, and that standardization would not yield any benefits, given varying investor preferences.<sup>1375</sup>

Because the rules will not apply to advisers with respect to SAFs that they advise, investors in SAFs will not benefit under the final rules.<sup>1376</sup> There may be forgone benefits because, for example, junior tranches of debt in SAFs carry higher risks that deteriorating performance of the SAF as measured by IRR and MOIC could impact their cash flows, and thus investors in junior tranches could have benefited from reporting of IRR and MOIC metrics as would have been required by the proposal.<sup>1377</sup> While equity tranches are typically only a small portion of the CLO, on the order of 10%, and a portion of the equity tranche of CLOs and other SAFs consists of the adviser and its related persons, there are still allocations of the equity tranche to certain outside investors, and those investors could have benefited under the final rules

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<sup>1373</sup> See, e.g., NYC Bar Comment Letter II; AIMA/ACC Comment Letter; Dechert Comment Letter; AIC Comment Letter I.

<sup>1374</sup> ICM Comment Letter.

<sup>1375</sup> See, e.g., Schulte Comment Letter; PIFF Comment Letter.

<sup>1376</sup> See *supra* sections II.AII.B, VI.C.3.

<sup>1377</sup> *Id.*

as well.<sup>1378</sup> The Commission staff are not aware of any data, and we did not receive any comment letters, that could measure SAF investor sensitivity to IRR and MOIC metrics, but to the extent investors are sensitive to such metrics, SAF investor benefits under the final rules have been reduced relative to the proposal by the loss of required reporting of those metrics.

However, we believe these forgone benefits are likely to be minimal, consistent with statements by commenters.<sup>1379</sup> Because investors in SAFs primarily hold debt interests in the fund, by definition,<sup>1380</sup> their primary performance concern is in evaluating the likelihood of full payment of the cash flows they are owed under the indenture corresponding to their agreed-upon defined return.<sup>1381</sup> This view is supported by industry comment letters.<sup>1382</sup> Because the final rules require reporting of performance metrics that pertain to the fund itself, those performance metrics may be of little or no informative use to debt investors receiving fixed payments along a waterfall structure. For example, a fund with a high IRR or MOIC that then experiences a reduction in its IRR or MOIC may not experience a reduction in its likelihood of repaying debt investors, and debt investors may not be able to determine if or when a reduction in IRR or MOIC results in a likelihood of their debt interests becoming impaired.

The performance reporting terms that CLOs and other SAFs typically currently rely on, by contrast, focus on tests of fund performance designed to measure the likelihood of successful payment of cash flows owed under an indenture, such as overcollateralization tests and interest coverage tests (*i.e.*, information relating to the quality, composition, characteristics and servicing

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<sup>1378</sup> *Id.*

<sup>1379</sup> *See, e.g.*, LSTA Comment Letter; SFA Comment Letter II; TIAA Comment Letter.

<sup>1380</sup> *See supra* sections II.A, VI.C.3.

<sup>1381</sup> *Id.*

<sup>1382</sup> *See, e.g.*, LSTA Comment Letter; SFA Comment Letter II; TIAA Comment Letter.

of the fund's portfolio assets).<sup>1383</sup> As a final matter, because CLO industry standard independent collateral administrator reports typically provide all relevant cash flows, and provide for estimated market values of every loan in the portfolio, investors in CLOs who would value information from IRR and MOIC could, in principle, estimate their own values from these metrics.<sup>1384</sup> Therefore, these forgone benefits relative to the proposal may be minimal.

Other commenters supported the proposed economic benefits of the enhanced and standardized performance disclosures.<sup>1385</sup> For example, to the extent that investors share the complete, comparable data with consultants or other intermediaries they work with (as is often current practice to the extent permitted under confidentiality provisions), this may allow such intermediaries to provide broader views across the private funds market or segments of the market. This may facilitate better decision making and capital allocation more broadly.

Similar to fee and expense reporting, variation across advisers in reporting practices means that the final rules will have two key interactions with Form PF reporting that affect the benefits of the final rules. First, because Form PF already collects performance information, the Commission may rely on data in Form PF to pursue potential outreach, examinations, or investigations, in response to any potential harm to investors associated with fund performance.<sup>1386</sup> Therefore, any investor protection benefits of the final rules may be mitigated to the extent that Form PF is already a sufficient tool for investor protection purposes regarding issues related to fund performance.<sup>1387</sup> This may also be the case for investors in funds advised

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<sup>1383</sup> See *supra* sections II.A, VI.C.3.

<sup>1384</sup> *Id.*

<sup>1385</sup> See, e.g., CII Comment Letter; NEA and AFT Comment Letter; OPERS Comment Letter.

<sup>1386</sup> Form PF Release, *supra* footnote 564.

<sup>1387</sup> See *supra* section VI.C.3.

by large hedge fund advisers, whose advisers will be subject to the new current reporting regime (after the new current reporting regime's effective date of 180 days after publication in the *Federal Register*).<sup>1388</sup> However, as with fee and expense reporting, we do not believe the benefits will be substantially mitigated, because Form PF is not an investor-facing disclosure form. Information that private fund advisers report on Form PF is provided to regulators on a confidential basis and is nonpublic.<sup>1389</sup> The benefits from the final rules accrue substantially from investors receiving enhanced and standardized information.

Second, the final rules may enhance the benefits from Form PF reporting, because Form PF reporting often only requires reporting on the basis of how advisers report information to investors.<sup>1390</sup> Standardizing practices of disclosures of performance reporting may improve data collected by Form PF, including data collected by the recently adopted Form PF current reporting regime (after the new current reporting regime's effective date of 180 days after publication in the *Federal Register*), improving Form PF's systemic risk assessment and investor protection benefits.

The required presentation of performance information and the resulting economic benefits will vary based on whether the fund is determined to be a liquid fund or an illiquid fund. For example, for private equity and other illiquid funds, investors will benefit from receiving multiple pieces of performance information, because the shortcomings discussed above that are associated with each method of measuring performance make it difficult for investors to evaluate fund performance from any singular piece of performance information alone, such as IRR or

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<sup>1388</sup> Form PF Release, *supra* footnote 564.

<sup>1389</sup> *See supra* section VI.C.3.

<sup>1390</sup> *See supra* section VI.C.3.

MOIC.<sup>1391</sup> This will improve investors’ ability to interpret performance reporting, and assess the relationship between the fees paid in connection with an investment and the return on that investment as they monitor their investment and consider potential future investments.

One commenter questioned the benefits of mandatory reporting of performance without the impact of subscription facilities, stating that reporting of performance without the impact of subscription facilities “does not provide a better view of ‘actual’ performance.”<sup>1392</sup> The commenter also states that “the Commission is mistaken that the levered performance obscures ‘actual’ performance.”<sup>1393</sup> We disagree with the argument underlying these statements. As discussed above, there is a documented literature on the use of subscription facilities to distort the results of performance reporting.<sup>1394</sup> We do not believe, and have not stated, that borrowing necessarily, or always, distorts actual performance: The Proposing Release stated, and we continue to believe, that subscription facilities can be and have been used to artificially boost reported IRRs, but because investors must pay the interest on the debt used, subscription facilities can potentially lower total returns for investors.<sup>1395</sup> We have further stated that subscription facilities can distort fund performance rankings and distort future fundraising outcomes,<sup>1396</sup> and we further understand from literature by investor groups that subscription facilities can artificially boost IRRs over the fund’s preferred return hurdle rate, resulting in the adviser receiving carried interest compensation in a scenario where the adviser would not have

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<sup>1391</sup> See *supra* section VI.C.3.

<sup>1392</sup> AIC Comment Letter I, Appendix 1.

<sup>1393</sup> *Id.*

<sup>1394</sup> See *supra* section VI.C.3.

<sup>1395</sup> Proposing Release, *supra* footnote 3, at 205-206; see also *supra* section VI.C.3.

<sup>1396</sup> See *supra* section VI.C.3; see also, e.g., Schillinger et al., *supra* footnote 1213; Enhancing Transparency Around Subscription Lines of Credit, *supra* footnote 1001.

received carried interest without the subscription line, and where the investor may not agree that the subscription line improved total returns and warranted a carried interest payment or where such early carried interest can create clawback complications later in the life of the fund.<sup>1397</sup>

We believe, therefore, that reporting of performance without the impact of subscription facilities does provide the investor with a better understanding of the value delivered by the adviser, absent any possible distortionary effect of the subscription facility, and enhances the standardization of disclosures about private funds.<sup>1398</sup> We also believe that performance without the impact of a subscription facilities does not tell the investor the actual dollar value of returns delivered. This motivates the final rule, in which reporting both with and without the impact of subscription facilities is required.<sup>1399</sup>

This commenter also stated that “the Commission is mistaken that excluding the impact of subscription facilities would necessarily increase net returns.”<sup>1400</sup> We have not stated that we believe there is any mathematical, necessary relationship between the impact of subscription facilities and net returns. We stated in the Proposing Release, and continue to believe, that subscription facilities *can be* and *sometimes are* used to manipulate reporting of returns, but not that they necessarily do in all cases. We believe subscription lines often deliver value to investors. However, we also continue to believe that there are cases when investors may not fully understand the impacts of subscription facilities on performance, and may not understand

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<sup>1397</sup> See *supra* section VI.C.3; see also Subscription Lines of Credit and Alignment of Interest, *supra* footnote 1211.

<sup>1398</sup> See *supra* sections VI.B, VI.C.3; see also Enhancing Transparency Around Subscription Lines of Credit, *supra* footnote 1001.

<sup>1399</sup> See *supra* section II.B.2.b).

<sup>1400</sup> AIC Comment Letter I, Appendix 1.

that a performance measure that depends on the timing of capital calls (such as IRR) has been distorted by use of a subscription facility.<sup>1401</sup>

One commenter questioned the benefits of disclosure of MOIC for unrealized and realized portions of a portfolio, and questioned if the proposed framework was intended to be analogous to TVPI/RVPI/DPI.<sup>1402</sup> As discussed above, there are key distinctions between unrealized and realized MOIC as separate from RVPI/DPI.<sup>1403</sup> We believe these distinctions result in key benefits from the disclosure of unrealized and realized MOIC. In the staff's experience, in the TVPI framework, substantial misvaluations applied to unrealized investments, when unrealized investments are a small portion of the fund's portfolio, may go undetected because in that case the denominator in the RVPI will be very large compared to the size of the misvaluation. By comparison, unrealized MOIC will have as a denominator just the called capital contributed to the unrealized investments, and so the misvaluation may be easier to detect.<sup>1404</sup>

For hedge funds, the primary benefit is the mandating of regular reporting of returns by advisers, standardizing the information provided by advisers across investors and over time.<sup>1405</sup>

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<sup>1401</sup> One commenter stated that in certain cases, the calculation of performance without the impact of subscription facilities could be challenging, particularly for historical periods. The commenter stated that advisers may not have identified the reasons for each capital call from investors, and may need to make assumptions about which historical capital calls would have been impacted. To the extent these assumptions by advisers are not accurate, the benefits of the information to investors will be reduced (and, as discussed below, the resulting complexity of the calculation may result in increased costs to advisers, which may be passed on to the fund and investors). *See* CFA Comment Letter I.

<sup>1402</sup> CFA Comment Letter I.

<sup>1403</sup> *See supra* section VI.C.3.

<sup>1404</sup> *Id.*

<sup>1405</sup> As a key related benefit that may accrue as a result of standardization, the required performance reporting under the final rules may mitigate potential biases associated with hedge funds choosing whether and when to report returns, as discussed above. *Id.* As discussed above, one commenter stated that "[t]he Proposed Rule also casts doubt on the reliability of public data on hedge fund performance . . . implying that these data may [] overstate fund performance. The Proposed Rule then suggests that its proposed restrictions will



This will improve investors’ ability to interpret performance reporting, and assess the relationship between the fees paid in connection with an investment and the return on that investment as they monitor their investment and consider potential future investments. The benefits from the final requirements are, however, potentially more substantial for illiquid funds, as the breadth of the performance information that will be required under the final rule for the private equity and other illiquid funds is designed to address the shortcomings of individual performance metrics.

For both types of funds, because the factors used to distinguish between liquid and illiquid funds rely on a narrow set of key distinguishing features that are included in the set of factors for determining how certain types of private funds should report performance under U.S. GAAP, market participants may be more likely to understand the presentation of performance. Investors will also benefit because the types of performance information required for each of liquid and illiquid funds are tailored to the circumstances facing investors in those funds. For illiquid fund investors who have limited or no ability to withdraw or redeem from a fund, annual returns in the middle of the life of the fund do not provide the same information as the cumulative or average performance of their investments since the fund’s inception, as is measured by the MOIC and IRR.<sup>1406</sup> Illiquid funds also typically experience what is deemed a “J-Curve” to their performance, making negative returns for investors in early years (as investor

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remedy this purported lack of price and quality competition.” *See supra* section VI.C.3; *see also* CCMR Comment Letter IV. As discussed above, we believe this mischaracterizes the Proposing Release. *See* Proposing Release, *supra* footnote 3, at 208, 230. Moreover, also as discussed above, additional literature illustrating variation in the bias of performance reporting by advisers. *See supra* section VI.C.3. We believe this further limits the ability to which commercial databases today can satisfy investor needs when evaluating their advisers, as investors cannot tell the direction of bias of any given adviser in the data. The literature cited by the commenter therefore further increases the likelihood of the benefits of the final rules, by mitigating these potential biases, instead of reducing the likelihood of the final rules generating the intended benefits. *Id.*

<sup>1406</sup> *See supra* section VI.C.3.

capital calls occur) and large positive returns in later years (as investments succeed and are exited, and proceeds are distributed), and annual returns for those individual years are therefore typically less informative for investors.<sup>1407</sup> By contrast, investors who are determining whether and when to withdraw from or request a redemption from a liquid fund will find annual net total returns over the past (at minimum) 10 years more informative than an IRR or MOIC measured since the fund's inception.<sup>1408</sup>

### *Costs*

The cost of the required performance disclosure by fund advisers will vary according to the existing practices of the adviser and the complexity of the required disclosure. For advisers who already (under their current practice) incur the costs of generating the necessary performance data, presenting and distributing it in a format suitable for disclosure to investors, and checking the disclosure for accuracy and completeness, the cost will likely be small. In particular, for those advisers, the cost of the performance disclosure may be limited to the cost of reformatting the performance information for inclusion in the mandated quarterly report. For example, because most advisers with fund-level subscription facilities are already reporting performance with the impact of such facilities, we do not anticipate that this requirement will entail substantial additional burdens for most advisers. For advisers who already both maintain the records needed to generate the required information and make the required disclosures, the costs will be even more limited. We anticipate this may be the case for many private fund

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<sup>1407</sup> *Id.* As discussed above, because these problems are exacerbated when the fund primarily invests in illiquid assets, as separate from when the investors' interests in the fund are illiquid, there may be certain liquid funds under the final rules for whom IRR and MOIC performance would be more beneficial to investors but the advisers to those funds will not be required under the rules to report IRR and MOIC. *Id.* However, advisers to such funds may already provide IRR and MOIC in their performance reporting, and moreover under the final rules investors may be more able to negotiate for such enhanced performance reporting. See *supra* footnotes 201, 228, and 1360 and accompanying discussion.

<sup>1408</sup> *Id.*

advisers, as we believe many private fund advisers already maintain and disclose similar information to what is required by the rule.<sup>1409</sup> For example, given that the rule will not apply to advisers with respect to SAFs that they advise, there will be no costs for advisers in the case of SAFs.<sup>1410</sup>

However, we understand that some advisers may face costs of changing their performance tracking or reporting practices under the current rule. Some of these costs will be direct costs of the rule requirements. Costs of updating an adviser's internal controls or internal compliance system to verify the accuracy and completeness of the reported performance information will be indirect costs of the rule. We expect the bulk of the costs associated with complying with this aspect of the final rules will likely be most substantial initially rather than on an ongoing basis.<sup>1411</sup> The lack of legacy status for this rule provision means that these costs will be borne across all private funds and advisers.<sup>1412</sup>

Some of these costs of compliance may again be affected by the rule provision providing that, to the extent doing so would provide more meaningful information and not be misleading, advisers must consolidate the quarterly statement reporting to cover similar pools of assets. These costs of compliance will be reduced to the extent that advisers are able to avoid duplicative costs across multiple statements, but will be increased to the extent that advisers must undertake costs associated with calculating feeder fund proportionate interests in a master fund,

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<sup>1409</sup> See *supra* section VI.C.3.

<sup>1410</sup> See *supra* section II.A.

<sup>1411</sup> The quantification of the direct costs associated with completing performance disclosures is included in the analysis of costs associated with fee and expense disclosures above.

<sup>1412</sup> There do not exist reliable data for quantifying what percentage of private fund advisers today engage in this activity or the other restricted activities. For the purposes of quantifying costs, including aggregate costs, we have applied the estimated costs per adviser to all advisers in the scope of the rule, as detailed in section VII.

to the extent advisers do not already do so. Commenters did not offer any opinion as to which of these two scenarios is generally more likely to be the case.

The required presentation of performance, and the resulting costs, will vary based on whether the fund is categorized as liquid or illiquid. In particular, for liquid funds, the cost is mitigated by the limited nature of the required disclosure, while the more detailed required disclosures for illiquid funds may require greater cost (yielding, as just discussed, greater benefit).<sup>1413</sup> For both categories of funds, because the set of factors we used to distinguish between liquid and illiquid funds is included in the current set of factors for determining how certain types of private funds should report performance under U.S. GAAP, market participants may be more familiar with these methods of presenting information, which may mitigate costs.

Under the final rule, these compliance costs may be borne by advisers and, where permissible, could be imposed on funds and therefore indirectly passed on to investors. For example, under current practice, advisers to private funds generally charge disclosure and reporting costs to the funds, so that those costs are ultimately paid by the fund investors. Similarly, to the extent advisers currently use service providers to assist with performance reporting (*e.g.*, administrators), those costs are often borne by the fund (and thus investors). We expect similar arrangements may be made going forward to comply with the final rule, with disclosure where required. Advisers may alternatively attempt to introduce substitute charges (for example, increased management fees) to cover the costs of compliance with the rule, but

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<sup>1413</sup> See *supra* sections II.B.2.a), II.B.2.b). For example, one commenter stated that in certain cases, the calculation of performance without the impact of subscription facilities could be challenging, particularly for historical periods. The commenter stated that advisers may not have identified the reasons for each capital call from investors, and may need to make assumptions about which historical capital calls would have been impacted. To the extent these assumptions by advisers result in difficult and costly calculations, these complications may result in further costs to advisers, which may be passed on to the fund and investors (and, as discussed above, benefits may be reduced). See CFA Comment Letter I.

their ability to do so may depend on the willingness of investors to incur those substitute charges. Some commenters stated that they believed these costs could be substantial, and that they would be more than likely to be borne by investors, not advisers.<sup>1414</sup> Another commenter also stated that it believed this would likely be the case with respect to required reporting of performance without the impact of subscription facilities.<sup>1415</sup>

Some commenters lastly expressed concerns that the rule posits a one-size-fits-all solution to performance reporting, and that with a required framework in place governing performance reporting, investors would face difficulties in negotiating for any reporting not specified in the final rules.<sup>1416</sup> While at the margin this may occur, we believe the final rules and this release appropriately leave investors and advisers free to negotiate any performance reporting terms not specified in the final rules (though that additional reporting must still comply with other regulations, such as the final marketing rule).<sup>1417</sup> As discussed above, we believe the final rules were designed to mitigate burden where possible and continue to facilitate competition and facilitate flexible negotiations between private fund parties.<sup>1418</sup>

Further, to the extent that the additional standardization and comparability of the information in the required disclosures make it easier for investors to compare and evaluate performance, the rule may prompt some investors to search for and seek higher performing investment opportunities. This could reduce the ability for advisers of low-performing funds to attract additional capital.

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<sup>1414</sup> AIC Comment Letter I; AIC Comment Letter II; CFA Comment Letter II; Ropes & Gray Comment Letter.

<sup>1415</sup> AIC Comment Letter I.

<sup>1416</sup> *See, e.g.*, AIC Comment Letter I; Schulte Comment Letter; NYC Bar Comment Letter II.

<sup>1417</sup> *See supra* section II.B.1.

<sup>1418</sup> *See supra* section VI.B.

### 3. Restricted Activities

The final rules restrict a private fund adviser from engaging in five types of activities with respect to the private fund or any investor in that private fund, with certain exceptions for where the adviser makes required disclosures and, in some cases, also obtains required investor consent.<sup>1419</sup> These activities are:<sup>1420</sup>

- (i) Charging fees or expenses associated with an examination or investigation of the adviser or its related persons;
- (ii) Charging regulatory or compliance expenses or fees of the adviser or its related persons;
- (iii) Reducing the amount of any adviser clawback by the amount of certain taxes;
- (iv) Charging fees and expenses related to a portfolio investment on a non-pro rata basis;
- (v) Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.<sup>1421</sup>

The non-pro rata restriction will be subject to an exception if the allocation approach is fair and equitable as well as a before-the-fact disclosure-based exception while the certain fees and expenses restrictions and the post-tax clawback restriction will be subject to after-the-fact disclosure-based exceptions only. The borrowing restriction and the investigation restriction will be subject to consent-based exceptions, which will require an adviser to receive advance consent from at least a majority in interest of a fund's investors that are not related persons of the adviser

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<sup>1419</sup> See *supra* section II.E.

<sup>1420</sup> See *supra* sections II.E, II.F.

<sup>1421</sup> We are not adopting the remaining two prohibitions (fees for unperformed services and indemnification) and have instead stated our views on the application of existing law. See *supra* section II.E.

in order to engage in these activities. However, the exception to the investigation restriction will not apply if the investigation results or has resulted in in the governmental or regulatory authority, or a court of competent jurisdiction, sanctioning the adviser or its related persons for violating the Act or the rules thereunder.<sup>1422</sup>

These restrictions will apply to activities of the private fund advisers even if they are performed indirectly, for example, by an adviser's related persons, recognizing that the potential for harm to the fund and its investors arises independently of whether the adviser engages in the activity directly or indirectly.

We discuss the costs and benefits of each of the final rules below.<sup>1423</sup> The Commission notes, however, that several factors make the quantification of many of these economic effects of the final amendments and rules difficult. For example, there is a lack of data on the extent to which advisers engage in certain of the activities that will be restricted under the final rules, as well as their significance to the businesses of such advisers. It is, therefore, difficult to quantify how costly it will be to comply with the restrictions. Similarly, it is difficult to quantify the benefits of these restrictions, because there is a lack of data regarding how and to what extent the changed business practices of advisers will affect investors, and how advisers may change their behavior in response to these rules. As a result, parts of the discussion below are qualitative in nature.

*Fees for exams, regulatory/compliance expenses, or investigations*

The final rules will restrict a private fund adviser from charging the fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by

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<sup>1422</sup> See *supra* section II.E.

<sup>1423</sup> Because the rule will not apply to advisers with respect to CLOs and other SAFs, there will be no benefits or costs for investors and advisers associated with those funds. See *supra* section II.A.

any governmental or regulatory authority or for the regulatory and compliance fees and expenses of the adviser or its related persons.<sup>1424</sup> While our policy choices for these types of restricted activities vary between disclosure, consent, and prohibition, the effects remain substantially similar, and so we discuss them in tandem.

We stated in the Proposing Release that we believed that these charges, even when disclosed, may create adverse incentives for advisers to allocate expenses to the fund at a cost to the investor, and as such they represent a possible source of investor harm.<sup>1425</sup> For example, when these charges are in connection with an investigation of an adviser, it may not be in the fund's best interest to bear the cost of the investigation.<sup>1426</sup> We further stated that these fees may also, even when disclosed, incentivize advisers to engage in excessive risk-taking, as the adviser will no longer bear the cost of any ensuing government or regulatory examinations or investigations.<sup>1427</sup> We discussed that by restricting this activity, investors would benefit from the reduced risk of having to incur costs associated with the adviser's adverse incentives, such as allocating inappropriate expenses to the fund. We discussed that investors would also be able to search across fund advisers knowing that these charges would not be assessed on any fund, which may lead to a better match between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes.

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<sup>1424</sup> See *supra* section II.E.1.a), II.E.2.a).

<sup>1425</sup> Proposing Release, *supra* footnote 3, at 234.

<sup>1426</sup> *Id.*

<sup>1427</sup> Fund adviser fees can allow the adviser to obtain leverage, and thereby gain disproportionately from successes, encouraging advisers to take on additional risk. See, e.g., Alon Brav, Wei Jiang & Rongchen Li, *Governance by Persuasion: Hedge Fund Activism and Market-Based Shareholder Influence*, Euro. Corp. Governance Inst. Fin., Working Paper No. 797/2021 (Dec. 10, 2021), available at <https://ssrn.com/abstract=3955116>.



Some commenters agreed with these benefits, stating that advisers should not be charging examination, investigation, regulatory and compliance fees and expenses to the fund.<sup>1428</sup> Many commenters, however, disagreed, stating that a prohibition would have negative consequences and disagreeing that prohibitions would generate benefits.<sup>1429</sup> For example, one commenter in particular stated that, because compliance costs increase with diversification of an adviser's portfolio, requiring advisers to bear costs of compliance would therefore discourage portfolio diversification.<sup>1430</sup> The commenter further stated that, if investors bear those costs, they can decide for themselves whether they are willing to pay extra compliance costs to achieve better diversification.<sup>1431</sup>

We recognize commenters' concerns, and as stated above we believe that our policy choice has benefited from taking into consideration the market problem that the policy is designed to address.<sup>1432</sup> Under the final rules, investors will benefit both in the case where (1) the activity in question continues but with enhanced disclosure and, in some cases, with enhanced consent practices, and (2) the adviser ceases the activity. These benefits will be mitigated to the extent advisers today already do not pass through these types of expenses to funds, or already do so subject to what will be required disclosures and after obtaining what will be required consent. As discussed above, reputational effects for advisers who pass through these expenses may already discipline the prevalence of these activities, as an adviser who passes through these expenses without disclosure or, in some cases, without consent, may have

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<sup>1428</sup> See, e.g., AFREF Comment Letter I; OPERS Comment Letter; NY State Comptroller Comment Letter.

<sup>1429</sup> See, e.g., Comment Letter of CSC Global Financial Markets (Apr. 25, 2022); NYC Bar Comment Letter II; ASA Comment Letter; Schulte Comment Letter; AIMA/ACC Comment Letter; SBAI Comment Letter.

<sup>1430</sup> See, e.g., Weiss Comment Letter; Maskin Comment Letter.

<sup>1431</sup> *Id.*

<sup>1432</sup> See *supra* section VI.B.

difficulties attracting investors after having done so.<sup>1433</sup> These considerations may mitigate benefits of the final rules, but they will also reduce the costs.

As discussed above, we believe whether such arrangements risk distorting adviser incentives to pay attention to compliance and legal matters, including matters related to investigations of potential conflicts of interest, may vary from adviser to adviser and may vary according to the type of expense. For regulatory, compliance, and examination expenses, the risk may be comparatively low, and requiring investor consent or prohibiting the activity altogether may not be necessary. However, even when investors bear these costs, it is necessary for them to at minimum receive disclosures of these costs. By contrast, in the case of investors bearing the costs of investigations by government or regulatory authorities, the risk of distorted adviser incentives may be higher, motivating further protections from additional consent requirements. Lastly, we do not believe there are reasonable cases where incentives are appropriately aligned by investors bearing the costs of investigations by government or regulatory authorities that results in the governmental or regulatory authority, or a court of competent jurisdiction, sanctioning the adviser or its related persons for violating the Act or otherwise finding that the adviser or its related persons violated the Act. Thus, in response to commenters, the final rules provide an exception to the restriction on regulatory, compliance, and examination expenses where the adviser makes certain disclosures, and an exception to the restriction on investigation expenses where the adviser obtains investor consent, but with the investigation expense exception not applying if the investigation results in a sanctioning or a finding as described above.<sup>1434</sup>

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<sup>1433</sup> See *supra* section VI.C.2.

<sup>1434</sup> See *supra* section II.E.

We continue to believe that the pass-through of these types of expenses can be associated with risks of adverse incentives for the adviser, such as allocating inappropriate expenses to the fund, or risks of incentives for the adviser to engage in excessive risk-taking. Under the final rules, investors will benefit from greater transparency into the risks that they will have to incur costs associated with these problems. Investors will be able to search across fund advisers knowing more clearly whether these charges will be assessed on a fund, which may lead to a better match between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes.

Investors will also benefit in cases where the adviser no longer charges the private fund clients for the restricted expenses, in particular with respect to costs of investigations that result in a sanctioning or a finding as described in the final rules. For the types of fees and expenses with a disclosure exception and, in some cases, a consent exception, investors may also benefit in cases where the adviser either opts to not make the required disclosure or obtain the required consent that would facilitate an exception, or may also occur in cases where the investors, having received disclosure of these expenses or when consent is sought, are able to negotiate for the adviser to bear the expense. We are providing legacy status for the aspects of the restricted activities rule that require investor consent, which include restricting an adviser from charging for certain investigation fees and expenses.<sup>1435</sup> This legacy status will mitigate the benefits to current funds that engage in pass-through of investigation expenses and the investors, but will also reduce costs for those advisers. We are also not applying legacy status to the aspects of the

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<sup>1435</sup> See *supra* section IV. For the avoidance of doubt, we have specified that the legacy status provision does not permit advisers to charge for 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 Act or the rules promulgated thereunder. See *supra* footnote 951.

restricted activities rule with disclosure-based exceptions because transparency into these practices is important and will not harm investors in the private fund.<sup>1436</sup> That means that these benefits will accrue across all private funds and advisers who currently engage in pass-through of these expenses.

As discussed further below, we believe most advisers will pursue compliance via the required disclosures and, in some cases, by obtaining the required consent, where they are able.<sup>1437</sup> The disclosures and, in some cases, consent requirements may enhance investor negotiating positions because, as discussed above, many investors report that they accept poor terms because they do not know what is “market.”<sup>1438</sup> Consistent with the Proposing Release, we believe investors in these cases will benefit from resolving any adverse incentives for the adviser created by passing-through the expenses at issue and any incentives for the adviser to engage in excessive risk-taking, which may lead to a better match between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes. Investors will also benefit from their improved ability to determine the appropriate amount of fund attention directed towards regulatory and compliance matters.

In these cases, the magnitude of the benefit will to some extent depend on whether advisers can introduce substitute charges (for example, increased management fees), and the willingness of investors to incur those substitute charges, for the purpose of making up any revenue that would be lost to the adviser from the restriction. However, any such substitute

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<sup>1436</sup> *Id.*

<sup>1437</sup> *See infra* footnote 1458 and accompanying text.

<sup>1438</sup> *See supra* section VI.B.

charges will be more transparent to the investor and will not create the same adverse incentives as the restricted charges, and so investors would likely ultimately still benefit.

Because Form PF's recently adopted new reporting requirements for private equity fund advisers will already collect annual information on the occurrence of general partner and limited partner clawbacks from large private equity advisers,<sup>1439</sup> any investor protection benefits of the final rules may be mitigated to the extent that Form PF is already a sufficient tool for investor protection purposes.<sup>1440</sup> However, we do not believe the benefits will be meaningfully mitigated, because Form PF is not an investor-facing disclosure form. Information that private fund advisers report on Form PF is provided to regulators on a confidential basis and is nonpublic, and by contrast the advisers who come into compliance with the restricted activities rule via the required disclosures will need to make those disclosures to investors. Moreover, the recently adopted Form PF reporting requirements are only applicable to large private equity advisers as defined by Form PF, which are those with at least \$2 billion in regulatory assets under management as of the last day of the adviser's most recently completed fiscal year,<sup>1441</sup> while the restricted activities rule will apply to all private fund advisers. While large private equity advisers cover approximately 73 percent of the private equity industry,<sup>1442</sup> and clawbacks are more common for private equity funds and other illiquid funds,<sup>1443</sup> there will still be benefits from consistently applying the restricted activities rule to all private fund advisers.

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<sup>1439</sup> See *supra* footnote 1153.

<sup>1440</sup> See *supra* section II.E.1.b).

<sup>1441</sup> See *supra* footnote 1153.

<sup>1442</sup> Form PF Release, *supra* footnote 564.

<sup>1443</sup> See *supra* sections II.E.1.b), VI.C.2.

The restriction will impose direct costs on advisers from the need to update their charging and contracting practices to bring them into compliance with the new requirements, in particular by making certain new disclosures and, in some cases, obtaining the new required investor consent. As discussed further below, in the context of the rule's impact on competition, commenters generally stated that they believed the direct costs of the rule would be high, given the compliance requirements involved.<sup>1444</sup>

Under the final rules, advisers will face costs both in the case where (1) the activity in question continues but with costs for enhanced disclosure, and (2) the adviser ceases the activity, with costs related to restructuring fund documents, higher expenses, or new or additional fees. For the restriction on passing through of expenses related to investigations by government or regulatory authorities that result or have resulted in the governmental or regulatory authority, or a court of competent jurisdiction, sanctioning the adviser or its related persons for violating the Act or the rules thereunder, advisers and funds will have no exception from the rule regardless of disclosures made or consent obtained. Similar to benefits, the costs will be reduced to the extent advisers today already do not pass through these types of expenses to funds, or already do so subject to what will be required disclosures and after obtaining what will be required consent, for example as a result of reputational effects.<sup>1445</sup> Also similar to benefits, the legacy status for the aspects of the restricted activities rule that require investor consent, which restrict an adviser from charging for certain investigation fees and expenses, will reduce the costs of the final rules for advisers with respect to those rules.<sup>1446</sup> We are not applying legacy status to the disclosure-

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<sup>1444</sup> See *infra* section VI.E.2.

<sup>1445</sup> See *supra* section VI.C.2.

<sup>1446</sup> See *supra* section IV.

based portions of the restricted activities rules, or to the prohibition on 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 Act or the rules promulgated thereunder,<sup>1447</sup> which means that the costs of those rules will be borne across all private funds and advisers who currently engage in pass-through of these expenses. In the case where advisers comply with the final rule by making the required disclosures and, in some cases, by obtaining the required consent, costs are quantified by examination of the analysis in section VII. As discussed below, based on IARD data, as of December 31, 2022, there were 12,234 investment advisers (including both registered and unregistered advisers, but excluding advisers managing solely SAFs) providing advice to private funds, and we estimate that these advisers would, on average, each provide advice to 8 private funds (excluding SAFs).<sup>1448</sup> We estimate that each of these advisers would require internal time costs from compliance attorneys, accounting managers, and assistant general counsels, yielding total internal time costs per adviser of \$29,344 across all restricted activities. We believe 75% of these advisers would also face total external costs of \$25,424 across all restricted activities. This means that aggregate internal time costs across these advisers would total \$358,994,496 across all of the restricted activities.<sup>1449</sup> We estimate that these advisers would also face aggregate external costs of \$233,290,624 across all advisers, for a total aggregate cost of \$592,285,120.<sup>1450</sup>

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<sup>1447</sup> *Id.*

<sup>1448</sup> *See infra* section VII.D. IARD data indicate that registered investment advisers to private funds typically advise more private funds as compared to the full universe of investment advisers.

<sup>1449</sup> *Id.*

<sup>1450</sup> *Id.*

We assume that this time is inclusive of time needed for advisers to make the determination that the requisite disclosure and, in some cases, consent is the appropriate path to compliance for that adviser. These costs also include the costs of making the requisite distributions of required disclosures to investors. For many private fund advisers, these costs will be limited by the timeline provided in the final rule for the requisite disclosures, requiring distribution within 45 days after the end of the fiscal quarter in which the relevant activity occurs, or 90 days after the end of the fiscal year for the fourth quarterly report, allowing many advisers that are subject to the quarterly statement rule to include these disclosures in their quarterly reports.<sup>1451</sup> However, certain fund advisers, such as advisers to funds of funds, may not make quarterly reports within a 45 day time frame, and those advisers may face additional costs associated with distribution of the required disclosures.

However, advisers may instead face direct costs associated with the need to update their charging and contracting practices to bring them into compliance with the new requirements in the case where advisers cease the restricted expense pass-through instead of making the required disclosures or instead of obtaining the required investor consent. These costs will be separate from PRA costs, which are limited to the costs associated with coming into compliance with the rules on restricted activities through making the required disclosures and, in some cases, obtaining the required investor consent.

As discussed in the Proposing Release, several factors make the quantification of these costs difficult, such as a lack of data on the extent to which advisers engage in the pass-through of expenses that will be restricted under the final rules.<sup>1452</sup> However, some commenters

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<sup>1451</sup> See *supra* section II.E.

<sup>1452</sup> Proposing Release, *supra* footnote 3, at 233-234.



criticized the Commission for acknowledging these direct costs but failing to quantify them.<sup>1453</sup>

In light of this, the Commission has further considered the requirement and additional work that would be required by various parties to comply. To that end, the Commission has estimated ranges of costs for compliance, depending on the amount of time each adviser will need to spend to comply. Some advisers may pass these direct costs on to their funds and thus investors, and other advisers may absorb these costs and bear the costs themselves.

Advisers are likely to vary in the complexity of their contracts and expense arrangements, because for example some advisers may not charge any expenses to a fund at all beyond management fees and carried interest. At minimum, we estimate that the additional work will require time from accounting managers (\$337/hour), compliance managers (\$360/hour), a chief compliance officer (\$618/hour), attorneys (\$484/hour), assistant general counsels (\$543/hour), junior business analysts (\$204/hour), financial reporting managers (\$339), senior business analysts (\$320/hour), paralegals (\$253/hour), senior operations managers (\$425/hour), operations specialists (\$159/hour), compliance clerks (\$82/hour), and general clerks (\$73/hour).<sup>1454</sup> Certain advisers may need to hire additional personnel to meet these demands. We also include time needed for advisers to make the determination that ceasing the restricted activity instead of making a disclosure and, in some cases, obtaining consent is the appropriate path to compliance for that adviser, which we estimate will require time from senior portfolio managers (\$383/hour) and senior management of the adviser (\$4,770/hour).

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<sup>1453</sup> See, e.g., Overdahl Comment Letter; LSTA Comment Letter, Exhibit C.

<sup>1454</sup> See *infra* section VII. One commenter stated that these wage rates may be underestimated. See AIC Comment Letter I, Appendix 1. But one commenter stated that these wage rates are conservatively high, and that commenter's quantification of total costs used lower wage rates from the Bureau of Labor Statistics. See LSTA Comment Letter, Exhibit C.

To estimate monetized costs to advisers, we multiply the hourly rates above by estimated hours per professional. Based on staff experience, we estimate that on average, advisers will require at minimum 24 hours of time from each of the personnel identified above as an initial burden for each of the restricted activities.<sup>1455</sup> For example, at minimum, each adviser may require time from these personnel to at least evaluate whether any revisions to their contracts are warranted at all. Multiplying these minimum hours by the above hourly wages yields a minimum initial cost of \$224,368.92 per adviser. These costs are likely to be higher initially than they are ongoing. Based on staff experience, we estimate minimum ongoing costs will likely be one third of the initial costs, or \$74,789.64 per year.<sup>1456</sup>

However, many of these potential direct costs of updates may be higher for certain advisers. Larger advisers, with more complex contracts and expense arrangements that are more complex to update, may have greater costs. Advisers may also vary in which investors consent to pass-through of investigation expenses. These variations across advisers could impact how many hours are needed from personnel. While the factors that may increase these costs are difficult to fully quantify, we anticipate that very few advisers would face a burden that exceeds 10 times the minimum estimate.<sup>1457</sup> Multiplying minimum initial cost estimates by 10 yields a

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<sup>1455</sup> This yields a total of 360 hours of personnel time for each of the restricted activities. We believe this is a reasonably large minimum estimate, as it applies for each restricted activity in question. For certain of these categories of professionals, these hours may be imposed on two professionals of each, who would face one-time costs of 12 hours each. For some, such as the Chief Compliance Officer, these hours would come/originate from one staff member, who may require 24 hours of time associated with each restricted activity.

<sup>1456</sup> The proportion of initial costs that will persist as ongoing costs is difficult to quantify and may vary from adviser to adviser, and also varies across different types of funds. To the extent the proportion of initial costs that persist as ongoing costs is higher than one third, the ongoing costs would be proportionally higher than what is reflected here.

<sup>1457</sup> Based on staff experience, as advisers grow in size, efficiencies of scale may emerge that limit the upper range of compliance costs. For example, an adviser in a large complex may have many contracts to revise, but these contracts may be substantially similar across funds.

maximum initial cost of \$2,243,689.20 per adviser. These costs are likely to be higher initially than they are ongoing. We estimate maximum ongoing costs will likely be one third of the initial costs, or \$747,896.40 per year.

The aggregate costs to the industry will depend on the proportion of advisers who pursue compliance via the required disclosures and via the required consent and the proportion of advisers who pursue compliance by forgoing the restricted activities. We believe that, in general, the substantial majority of advisers will pursue compliance with the final rule via disclosures and via consent as opposed to by ceasing the required activities.<sup>1458</sup> We therefore believe that the aggregate compliance costs to the industry associated with this component of the final rule will likely be consistent with the aggregate costs to the industry as reflected in the PRA analysis. This is supported by the fact that the costs we estimate to each adviser of complying with the final rules by ceasing the restricted activity (in particular, potentially as high as \$2,243,689.20 in initial costs) is much higher than the PRA cost per adviser across all restricted activities (\$54,768). However, to the extent that more than a *de minimis* number of advisers pursue compliance through ceasing the restricted activity instead of via disclosures and via consent, aggregate costs may be higher.<sup>1459</sup>

Similar to the benefits, advisers may also incur costs related to this restriction in connection with not being able to charge private fund clients for the restricted expenses, in cases where the adviser opts to not make the required disclosure or, in some cases, obtain the required consent that would facilitate an exception. This may also occur in cases where the investors, having received disclosure of these expenses or when consent is sought, are able to negotiate for

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<sup>1458</sup> See *infra* section VII.D.

<sup>1459</sup> See *infra* footnote 1533.

the adviser to bear the expense, for example by withholding consent. In addition, in these cases, advisers may incur indirect costs related to adapting their business models to identify and substitute non-restricted sources of revenue. For example, advisers may identify, negotiate, and implement methods of replacing the lost charges from the restricted practice with other charges to the fund, and so investors may bear such additional costs.<sup>1460</sup>

Further, as discussed above, we understand that certain private fund advisers, most notably advisers to hedge funds and other liquid funds,<sup>1461</sup> utilize a pass-through expense model where the private fund pays for most, if not all, of the adviser's expenses in lieu of being charged a management fee. Commenters expressed substantial concerns with the notion that pass-through expense models, or portions of these models, would be prohibited or restricted by the rule, stating that pass-through expense models can be in the best interest of investors, and can in fact enhance fee and expense transparency.<sup>1462</sup>

The final rules substantially address these commenters' concerns, in that pass-through expense models would not have most aspects of their business model expressly prohibited by the final rules (except for the pass-through of expenses associated with investigations that result or have resulted in sanctioning the adviser for violating the Act or the rules thereunder as described in the final rules), as advisers to those fund models can comply with the restrictions in the rules via the required disclosures. The final rules will, however, likely impact certain aspects of pass-through expense models or other similar models in which advisers charge investors expenses

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<sup>1460</sup> However, any such costs of alternative charges would be mitigated by the adviser needing to negotiate and disclose such charges, for example in quarterly statements of fees and expenses. *See supra* section II.B.1.

<sup>1461</sup> *See, e.g.,* Eli Hoffmann, *Welcome To Hedge Funds' Stunning Pass-Through Fees*, SEEKING ALPHA (Jan. 24, 2017), *available at* <https://seekingalpha.com/article/4038915-welcome-to-hedge-funds-stunning-pass-through-fees>.

<sup>1462</sup> *See, e.g.,* MFA Comment Letter I, Appendix A; Overdahl Comment Letter.

associated with certain of the adviser's cost of being an investment adviser, because these business models may in general need to pursue the necessary disclosures to have an exception from the restriction, or otherwise undertake substantial costs to restructure their fund's business model to generate other sources of revenue, such as a new management fee,<sup>1463</sup> and will in general need to pay without passing through fees or expenses associated with a violation of the Act.<sup>1464</sup> For example, an adviser may have investors who have consented to investigation expenses, and for an ongoing investigation the adviser may be passing through those investigation expenses, but upon the occurrence of a finding that the adviser violated the Act the adviser will need to identify funding to reimburse the fund for previously passed-through expenses. In that case, advisers who are not already equipped to pay such expenses will need to identify other assets (*e.g.*, balance sheet capital), sources of revenue (*e.g.*, a new management fee or increased performance-based compensation), or access to capital (*e.g.*, loans) to pay any such fees or expenses.<sup>1465</sup>

There are two factors that mitigate these impacts for advisers to pass-through funds and their investors. First, as the Commission may already require advisers to pass-through funds to pay penalties associated with a violation the Act, we anticipate that this rule will not cause a significant disruption from current practice for advisers to pass-through funds.<sup>1466</sup> Second, more generally, we believe pass-through funds already provide ongoing, regular disclosure of the other fees and expenses that are being passed through to investors and these investors have consented

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<sup>1463</sup> However, any such costs of alternative charges would be mitigated by the adviser needing to negotiate and disclose such charges, for example in quarterly statements of fees and expenses. *See supra* section II.B.1.

<sup>1464</sup> *See supra* sections II.E.1.a), II.E.2.a).

<sup>1465</sup> *Id.*

<sup>1466</sup> *Id.*

to the pass-through of these expenses, and thus are most likely already well-positioned to come into compliance with the final rule through the necessary disclosures and consent requirements.<sup>1467</sup>

To the extent advisers to pass-through expense funds pursue such restructuring, the expenses that will no longer be passed through to the fund will require the adviser to negotiate a new fixed management fee to compensate for the new costs. In addition, any such fund restructurings that are undertaken will likely impose costs that will be borne by advisers. The costs may also be borne partially or entirely by the private funds, to the extent permissible or to the extent advisers are able to compensate for their costs with substitute charges (for example, increased management fees). To the extent that existing pass-through structures are more efficient than the resulting structures that may emerge, as some commenters have stated, that may represent an additional cost of the rule.<sup>1468</sup> As a related cost, fund advisers unable to fully compensate for formerly passed-through costs with new fees may reduce their costs, possibly with inefficiently low investment in compliance, and reduced investments in compliance may result in additional expenses for the fund or adviser in the future or reductions to activities designed to protect investors.<sup>1469</sup>

In addition, investors may incur costs from this restriction that take the form of lower returns from some fund investments, depending on the extent to which the restriction limits the adviser's efficiency or effectiveness in providing the services that generate returns from those investments. For example, in the case of pass-through expense models, fund advisers who would

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<sup>1467</sup> See *supra* section II.E.1.a).

<sup>1468</sup> See, e.g., Overdahl Comment Letter; AIC Comment Letter I, Appendix 1.

<sup>1469</sup> AIC Comment Letter I, Appendix 1.

have to bear new costs of providing certain services under the restriction may reduce or eliminate those services to reduce costs, which may be to the detriment of the fund's performance or lead to an increase of compliance risk. The restriction in the final rules may also represent an incentive for advisers to take fewer risks, to reduce risks of examinations or investigations occurring in the first place, which may lower investor returns.

Moreover, to the extent that restructuring a pass-through expense model of a hedge fund under the final rule diverts the hedge fund adviser's resources away from the hedge fund's investment strategy, this could lead to a lower return to investors in hedge funds. The cost of lower returns would be mitigated to the extent that certain investors can distinguish and identify those funds that require restructuring as to how they collect revenue from investors and use this information to search for and identify substitute funds that have expense models that do not need to be restructured under the rule and that do not present the investor with reduced returns as a result of the rule.<sup>1470</sup> While some investors may face difficulty today in determining whether their next investment should be with the same or a different adviser,<sup>1471</sup> they may have an improved ability to do so as a result of the enhanced transparency under the final rules. Investors would also need to evaluate whether these substitute funds would be likely to present them with better performance than their current funds. Any such search costs would be a cost of the rule. As a result, the cost to investors may include a combination of the cost of lower returns and the cost of seeking to avoid or mitigate such reductions in returns.

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<sup>1470</sup> To the extent that these substitute funds that do not need to be restructured under the rule have higher expenses than funds whose structures are impacted, but the compliance costs of the rule cause impacted funds to become the higher expense funds, than investors may still face higher expenses and reduced returns. For example, some commenters state that pass-through funds are lower expense funds than other types of private funds, and so to the extent higher compliance costs create higher expenses for pass-through funds, investors may face higher expenses and lower returns regardless of their ability to rotate to other fund types. *See, e.g.,* Overdahl Comment Letter; Sullivan & Cromwell Comment Letter.

<sup>1471</sup> *See supra* section VI.B.

### *Reducing Adviser Clawbacks for Taxes*

The final rule will restrict certain uses of fund resources by the private fund adviser by restricting advisers from reducing the amount of their clawback obligation by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders, unless the adviser distributes a written notice to the investors of such private fund client that sets forth the aggregate dollar amounts of the adviser clawback before and after any reduction for actual, potential, or hypothetical taxes within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.<sup>1472</sup>

Investors in funds with advisers who would have otherwise reduced clawbacks for taxes, but under the rule will make no such reduction, will benefit from this rule from increases to clawbacks (and thus investor returns) by actual, potential, or hypothetical tax rates. Investors in funds with advisers who will continue to reduce clawbacks for taxes but will make the required disclosure will benefit from their enhanced ability to monitor the adviser and prevent the adviser from putting its interests ahead of the funds' interests. Current investors in a fund who receive these disclosures, and who are contemplating investing in a follow-on fund with the same adviser, may also benefit from these disclosures through an enhanced ability to negotiate terms of the follow-on fund, for example by negotiating that the adviser to the follow-on fund will not reduce clawbacks for taxes in the follow-on fund. The disclosures may enhance investor negotiating positions because, as discussed above, many investors report that they accept poor terms because they do not know what is "market."<sup>1473</sup> Such investors will benefit from

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<sup>1472</sup> See *supra* section II.E.1.b).

<sup>1473</sup> See *supra* section VI.B.



effectively increased clawbacks in their follow-on funds.<sup>1474</sup> Many commenters agreed that investors could benefit from restricting the practice of reducing clawbacks for taxes.<sup>1475</sup> The lack of legacy status for this rule provision means that these benefits will accrue across all private funds and advisers who currently engage in clawbacks. Because clawbacks are more common for private equity funds and other illiquid funds,<sup>1476</sup> these benefits will generally be more applicable to advisers and investors in those funds.

Commenters who opposed a prohibition generally did not specify any objection to the purported benefits of the rule, and instead emphasized the indirect costs of the rule. Specifically, many commenters stated that the indirect costs of the rule, as proposed, would have been very high. As discussed above, commenters stated that indirect costs and unintended consequences could have included the reduction of advisers that choose to offer clawback mechanisms in their private funds, the restructurings of current performance-based compensation arrangements into arrangements that would be less favorable for investors, offsetting changes to other economic terms applicable to investors (*e.g.*, higher management fees), the distortion of timely portfolio management decisions to avoid potential clawback liabilities, and disproportionate burdens on smaller investment advisers that may be more reliant on the receipt of performance-based compensation on a deal-by-deal basis to remunerate their employees and fund their

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<sup>1474</sup> Because commenters generally emphasized that clawbacks have developed through robust negotiations between advisers and their private fund clients, investors may generally be more likely to benefit from the enhanced information that they will receive under the final rule, instead of from advisers voluntarily forgoing the reduction of clawbacks for taxes.

<sup>1475</sup> *See, e.g.*, AFL-CIO Comment Letter; Albourne Comment Letter; Better Markets Comment Letter; Convergence Comment Letter; NASAA Comment Letter; NYC Comptroller Comment Letter; OPERS Comment Letter.

<sup>1476</sup> *See supra* sections II.E.1.b), VI.C.2.

operations.<sup>1477</sup> We believe that the final rule substantially mitigates the risks of these unintended consequences and costs by allowing for advisers to still reduce clawbacks for taxes, in the event they make the required disclosures. As stated above, we also believe that our policy choice has benefited from taking into consideration the market problem that the policy is designed to address, and believe that the final rule with an exception for certain disclosures accomplishes this.<sup>1478</sup>

This restriction will still impose direct costs on advisers of either (i) updating their charging and contracting practices to bring them into compliance with the new requirements, or (ii) making the relevant disclosures. Advisers may also attempt to mitigate the greater costs of clawbacks under the restriction, including the costs of disclosures, by introducing some new fee, charge, or other contractual provision that would make up for the lost tax reduction on the clawback, and they will then incur costs of updating their contracting practices to introduce these new provisions.<sup>1479</sup> As discussed further below, in the context of the rule's impact on competition, commenters generally stated that they believed the direct costs of the rule would be high, given the compliance requirements involved.<sup>1480</sup> The lack of legacy status for this rule provision means that these costs will be borne across all private funds and advisers who currently engage in clawbacks. Because clawbacks are more common for private equity funds and other

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<sup>1477</sup> See *supra* section VI.C.3; see also, e.g., AIC Comment Letter I, Appendix I; Ropes & Gray Comment Letter.

<sup>1478</sup> See *supra* section VI.B.

<sup>1479</sup> Under the proposal, the Commission stated that some advisers may be unable to recoup the cost of the tax payments made in connection with the excess distributions and allocations affected by the proposal, and therefore would face greater costs when clawbacks do occur under the prohibition. Proposing Release, *supra* footnote 3, at 22. We believe we have removed that potential cost, as we expect any such advisers who would have been unable to recoup the cost of the tax payment under the proposal will instead under the final rule make the required disclosures.

<sup>1480</sup> See *infra* section VI.E.2.

illiquid funds,<sup>1481</sup> these costs will generally be more applicable to advisers and investors in those funds.<sup>1482</sup>

Advisers who forgo reducing clawbacks for taxes because of the final rule, either voluntarily or in a follow-on fund where investors used the enhanced disclosure in the prior fund to negotiate such terms, may attempt to mitigate their increased costs associated with clawbacks by reducing the risk of a clawback occurring. For example, certain advisers may adopt new waterfall arrangements designed to delay carried interest payments until later in the life of a fund, to limit the possibility of a clawback or reduce the possible sizes of clawbacks. In this case, investors will benefit from earlier distributions of proceeds from the fund and reduced costs associated with monitoring their potential need for a clawback. However, some fund advisers are able to attract investors even though their fund terms do not provide for full or partial clawbacks. To the extent such advisers were able to update their business practices, for example by providing for an advance on tax payments with no option for a clawback, this will reduce the benefits of the rule, as investors would continue to receive the reduced clawback amounts and bear portions of the adviser's tax burden. In either case, advisers will also bear additional costs from the final rule of updating their business practices.

Advisers could, therefore, incur transitory costs related to adapting their business models to identify and substitute non-restricted sources of revenue. These direct costs may be particularly high in the short term to the extent that advisers renegotiate, restructure, and/or revise certain existing deals or existing economic arrangements in response to this restriction.

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<sup>1481</sup> See *supra* sections II.E.1.b), VI.C.2.

<sup>1482</sup> However, there do not exist reliable data for quantifying what percentage of private fund advisers today engage in this activity or the other restricted activities. For the purposes of quantifying costs, including aggregate costs, we have applied the estimated costs per adviser to all advisers in the scope of the rule, consistent with the approach taken in the PRA analysis. See *supra* section VII.

In the case where advisers comply with the final rule by making the required disclosures, costs are quantified by examination of the analysis in section VII, which have been tallied along with all other disclosure costs of the restricted activities above and include time needed for advisers to make the determination that the requisite disclosure is the appropriate path to compliance for that adviser.<sup>1483</sup> These costs also include the costs of making the requisite distributions to investors. For many private fund advisers, these costs will be limited by the timeline providing in the final rule, requiring distribution within 45 days after the end of the fiscal quarter in which the relevant activity occurs, or 90 days after the end of the fiscal year for the fourth quarterly report, allowing many advisers that are subject to the quarterly statement rule to include these disclosures in their quarterly reports.<sup>1484</sup> However, certain fund advisers, such as advisers to funds of funds, may not make quarterly reports within a 45 day time frame, and those advisers may face additional costs associated with distribution of the required disclosures.

However, advisers may instead face direct costs associated with the need to update their charging and contracting practices to bring them into compliance with the new restriction, in particular in the case where advisers cease the restricted clawbacks instead of making the required disclosures. These costs will be separate from PRA costs, which are limited to the costs associated with coming into compliance with the rules on restricted activities through making the required disclosures, and include time needed for advisers to make the determination that the ceasing the restricted activity is the appropriate path to compliance for that adviser.

As discussed in the Proposing Release, several factors make the quantification of these costs difficult, such as a lack of data on the extent to which advisers engage in the reduction

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<sup>1483</sup> See *supra* footnote 1450 and accompanying text.

<sup>1484</sup> See *supra* section II.E.

clawbacks for taxes that will be restricted under the final rules.<sup>1485</sup> However, some commenters criticized the Commission for acknowledging these direct costs but failing to quantify them.<sup>1486</sup> In light of this, the Commission has further considered the requirement and additional work that would be required by various parties to comply. To that end, the Commission has estimated ranges of costs for compliance, depending on the amount of time each adviser will need to spend to comply. Some advisers may pass these direct costs on to their funds and thus investors, and other advisers may absorb these costs and bear the costs themselves.

Advisers are likely to vary in the complexity of their contracts and clawback arrangements, because for example some advisers may already refrain from reducing clawbacks for taxes. At minimum, we estimate that the additional work will require time from accounting managers (\$337/hour), compliance managers (\$360/hour), a chief compliance officer (\$618/hour), attorneys (\$484/hour), assistant general counsel (\$543/hour), junior business analysts (\$204/hour), financial reporting managers (\$339), senior business analysts (\$320/hour), paralegals (\$253/hour), senior operations managers (\$425/hour), operations specialists (\$159/hour), compliance clerks (\$82/hour), and general clerks (\$73/hour).<sup>1487</sup> Certain advisers may need to hire additional personnel to meet these demands. We also include time needed for advisers to make the determination that ceasing the restricted activity instead of making a disclosure is the appropriate path to compliance for that adviser, which we estimate will require time from senior portfolio managers (\$383/hour) and senior management of the adviser (\$4,770/hour).

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<sup>1485</sup> Proposing Release, *supra* footnote 3, at 233-234.

<sup>1486</sup> See, e.g., Overdahl Comment Letter; LSTA Comment Letter, Exhibit C.

<sup>1487</sup> See *infra* section VII.

To estimate monetized costs to advisers, we multiply the hourly rates above by estimated hours per professional. Based on staff experience, we estimate that on average, advisers will require at minimum 24 hours of time from each of the personnel identified above as an initial burden.<sup>1488</sup> For example, at minimum, each adviser may require time from these personnel to at least evaluate whether any revisions to their contracts are warranted at all. Multiplying these minimum hours by the above hourly wages yields a minimum initial cost of \$224,368.92 per adviser. These costs are likely to be higher initially than they are ongoing. We estimate minimum ongoing costs will likely be one third of the initial costs, or \$74,789.64 per year.<sup>1489</sup>

However, many of these potential direct costs of updates may be higher for certain advisers. Larger advisers, with more complex contracts and expense arrangements that are more complex to update, may have greater costs. While the factors that may increase these costs are difficult to fully quantify, we anticipate that very few advisers would face a burden that exceeds 10 times the minimum estimate.<sup>1490</sup> Multiplying minimum initial cost estimates by 10 yields a maximum initial cost of \$2,243,689.20 per adviser. These costs are likely to be higher initially than they are ongoing. We estimate maximum ongoing costs will likely be one third of the initial costs, or \$747,896.40 per year.

The aggregate costs to the industry will depend on the proportion of advisers who pursue compliance via the required disclosures and the proportion of advisers who pursue compliance by forgoing the restricted activity. We believe that, in general, almost all advisers will pursue

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<sup>1488</sup> As discussed above, this yields a total of 360 hours of personnel time for each of the restricted activities. *See supra* footnote 1455.

<sup>1489</sup> As discussed above, to the extent the proportion of initial costs that persist as ongoing costs is higher than one third, the ongoing costs will be proportionally higher than what is reflected here. *See supra* footnote 1456.

<sup>1490</sup> As discussed above, based on staff experience, as advisers grow in size, efficiencies of scale may emerge that limit the upper range of compliance costs. *See supra* footnote 1457.

compliance with the final rule via disclosures as opposed to by ceasing the restricted activity.<sup>1491</sup> We therefore believe that the aggregate costs to the industry associated with this component of the final rule will likely be consistent with the aggregate costs to the industry as reflected in the PRA analysis. This is supported by the fact that the costs we estimate to each adviser of complying with the final rules by ceasing the restricted activity (in particular, potentially as high as \$2,243,689.20 in initial costs) is much higher than the PRA cost per adviser across all restricted activities (\$54,768). However, to the extent that more than a *de minimis* number of advisers pursue compliance through ceasing the restricted activity instead of via disclosures, aggregate costs may be higher.<sup>1492</sup>

#### *Certain Non-Pro Rata Fee and Expense Allocations*

The final rule will restrict a private fund adviser from charging certain fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment unless the adviser satisfies a requirement that the allocation be fair and equitable and a requirement to, before charging or allocating such fees or expenses to a private fund client, distribute to each investor of the private fund a written notice of the non-pro rata charge or allocation and a description of how the allocation approach is fair and equitable under the circumstances.<sup>1493</sup>

The Proposing Release stated that these non-pro rata fee and expense allocations tend to adversely affect some investors who are placed at a disadvantage to other investors.<sup>1494</sup> We

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<sup>1491</sup> See *infra* section VII.D.

<sup>1492</sup> See *infra* footnote 1533.

<sup>1493</sup> See *supra* section II.E.1.b).

<sup>1494</sup> Proposing Release, *supra* footnote 3, at 240.

associated these practices and disadvantages with a tendency towards opportunistic hold-up of investors by advisers, involving exploitation of an informational or bargaining advantage.<sup>1495</sup> The disadvantaged investors currently pay greater than their pro rata shares of fees and expenses. The disparity may arise from differences in the bargaining power of different investors. For example, a fund adviser may have an incentive to assign lower than pro rata shares of fees and expenses to larger investors that bring repeat business to the adviser and correspondingly lower pro rata shares to the smaller investors paying greater than pro rata shares.

We continue to believe that this may generally be the case. Several commenters supported the proposed provision, agreeing that it may protect investors.<sup>1496</sup> However, many commenters argue that there are also many fair and equitable reasons for different investors to bear different portions of fees and expenses.<sup>1497</sup> As stated above, we believe that our policy choice has benefited from taking into consideration the market problem that the policy is designed to address, and believe that this is accomplished by the final rule with an exception for advisers who make certain advance disclosures.<sup>1498</sup> This is because under the final rule, investors will have an enhanced ability to monitor their funds' advisers for inappropriate opportunistic apportioning of fees and expenses, but advisers will still be able to apportion fees on a non-pro rata basis when it is fair and equitable to do so, as long as the required disclosures are made. Current investors in a fund who receive these disclosures, and who are contemplating investing in a follow-on fund with the same adviser, may also benefit from these disclosures

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<sup>1495</sup> *Id.* See also *infra* section VI.D.4 (discussing opportunism in the context of certain preferential treatment).

<sup>1496</sup> See, e.g., NY State Comptroller Comment Letter; AFL-CIO Comment Letter; ILPA Comment Letter I; ICCR Comment Letter; IAA Comment Letter II.

<sup>1497</sup> See, e.g., SBAI Comment Letter; IAA Comment Letter II; Ropes & Gray Comment Letter.

<sup>1498</sup> See *supra* section VI.B.



through an enhanced ability to negotiate terms of the follow-on fund, for example by negotiating that the follow-on fund will not engage in any non-pro rata fee and expense allocations. The disclosures may enhance investor negotiating positions because, as discussed above, many investors report that they accept poor terms because they do not know what is “market.”<sup>1499</sup>

Investors in funds with advisers who forgo non-pro rata fee and expense allocations because of the final rule, either voluntarily or in a follow-on fund where investors used the enhanced disclosure in the prior fund to negotiate such terms, may either benefit or face costs from the resulting revised apportionment of expenses. This will depend on whether their share of expenses is decreased or increased under the rule. Investing clients in these portfolio investments paying greater than pro rata shares of such fees and expenses will benefit as a result of lowered fees and expenses. However, to the extent that a client was previously able to obtain fee and expense allocations at rates less than a pro rata apportionment, the client could incur higher fee and expense costs in the future.

The enhanced disclosures will also benefit investors directly. Investors may not be aware of the extent to which fees and expenses are charged on a non-pro-rata basis. Even if an adviser discloses upfront that non-pro rata fee and expense allocations may occur throughout the life of the fund, the complexity of fee and expense arrangements may mean that these arrangements are hard to follow. Even larger or more sophisticated investors, with greater bargaining power, may be aware that they risk non-pro-rata fees, but nonetheless be harmed by the uncertainty from complex fee arrangements, and so even larger investors may benefit from this enhanced transparency.

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<sup>1499</sup> See *supra* section VI.B.

The lack of legacy status for this rule provision means that these benefits will accrue across all private funds and advisers who currently engage in non pro-rata allocations of fees and expenses. Because such allocations are more common for private equity funds and other illiquid funds,<sup>1500</sup> these benefits will generally be more applicable to advisers and investors in those funds.

The final rule will impose direct costs on advisers who must either update their charging and contracting practices to bring them into compliance with the new requirements or provide the required disclosures. These compliance costs may be particularly high in the short term to the extent that advisers renegotiate, restructure, and/or revise certain existing deals or existing economic arrangements in response to this restriction. Advisers who forgo non-pro rata fee and expense allocations because of the final rule, either voluntarily or in a follow-on fund where investors used the enhanced disclosure in the prior fund to negotiate such terms, may face additional costs in the form of lower expenses and fees, to the extent that less flexible pro-rata fee and expense allocations result in lower average fees and expenses to the adviser or are more costly to administer and monitor. These effects may impact the use of co-investment vehicles: To the extent that advisers, in response to the final rule, increase the fees passed on to co-investment vehicles that absent the rule would have borne less than their pro-rata share of fees, the rule may reduce the attractiveness of co-investment vehicles to investors. This may reduce the liquidity available for certain illiquid funds that currently rely on co-investment vehicles for raising money for specific portfolio investments.

In the case where advisers comply with the final rule by making the required disclosures, costs are quantified by examination of the analysis in section VII, which have been tallied along

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<sup>1500</sup> See *supra* sections II.E.1.c), VI.C.2.

with all other disclosure costs of the restricted activities above and include time needed for advisers to make the determination that the requisite disclosure is the appropriate path to compliance for that adviser.<sup>1501</sup> These costs also include the costs of making the requisite distributions to investors. For many private fund advisers, these costs will be limited by the timeline provided in the final rule, requiring distribution within 45 days after the end of the fiscal quarter in which the relevant activity occurs, or 90 days after the end of the fiscal year for the fourth quarterly report, allowing many advisers that are subject to the quarterly statement rule to include these disclosures in their quarterly reports.<sup>1502</sup> However, certain fund advisers, such as advisers to funds of funds, may not make quarterly reports within a 45 day time frame, and those advisers may face additional costs associated with distribution of the required disclosures.

However, advisers may instead face direct costs associated with the need to update their charging and contracting practices to bring them into compliance with the new requirements, in particular in the case where advisers cease non-pro rata allocations of fees and expenses instead of making the required disclosures. As discussed in the Proposing Release, several factors make the quantification of these costs difficult, such as a lack of data on the extent to which advisers engage in non-pro rata allocations of fees and expenses.<sup>1503</sup> However, some commenters criticized the Commission for acknowledging these direct costs but failing to quantify them.<sup>1504</sup> In light of this, the Commission has further considered the requirement and additional work that would be required by various parties to comply. To that end, the Commission has estimated ranges of costs for compliance, depending on the amount of time each adviser will need to spend

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<sup>1501</sup> See *supra* footnote 1450 and accompanying text.

<sup>1502</sup> See *supra* section II.E.

<sup>1503</sup> Proposing Release, *supra* footnote 3, at 233-234.

<sup>1504</sup> See, e.g., Overdahl Comment Letter; LSTA Comment Letter, Exhibit C.

to comply. Some advisers may pass these direct costs on to their funds and thus investors, and other advisers may absorb these costs and bear the costs themselves.

Advisers are likely to vary in the complexity of their contracts and fee and expense allocation arrangements, because for example some advisers may already refrain from ever implementing non-pro rata allocations of fees and expenses. At minimum, we estimate that the additional work will require time from accounting managers (\$337/hour), compliance managers (\$360/hour), a chief compliance officer (\$618/hour), attorneys (\$484/hour), assistant general counsel (\$543/hour), junior business analysts (\$204/hour), financial reporting managers (\$339), senior business analysts (\$320/hour), paralegals (\$253/hour), senior operations managers (\$425/hour), operations specialists (\$159/hour), compliance clerks (\$82/hour), and general clerks (\$73/hour).<sup>1505</sup> Certain advisers may need to hire additional personnel to meet these demands. We also include time needed for advisers to make the determination that ceasing the restricted activity instead of making a disclosure is the appropriate path to compliance for that adviser, which we estimate will require time from senior portfolio managers (\$383/hour) and senior management of the adviser (\$4,770/hour).

To estimate monetized costs to advisers, we multiply the hourly rates above by estimated hours per professional. Based on staff experience, we estimate that on average, advisers will require at minimum 24 hours of time from each of the personnel identified above as an initial burden.<sup>1506</sup> For example, at minimum, each adviser may require time from these personnel to at least evaluate whether any revisions to their contracts are warranted at all. Multiplying these minimum hours by the above hourly wages yields a minimum initial cost of \$224,368.92 per

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<sup>1505</sup> See *infra* section VII.

<sup>1506</sup> As discussed above, this yields a total of 360 hours of personnel time for each of the restricted activities. See *supra* footnote 1455.

adviser. These costs are likely to be higher initially than they are ongoing. Based on staff experience, we estimate minimum ongoing costs will likely be one third of the initial costs, or \$74,789.64 per year.<sup>1507</sup>

However, many of these potential direct costs of updates may be higher for certain advisers. Larger advisers, with more complex contracts and expense arrangements that are more complex to update, may have greater costs. While the factors that may increase these costs are difficult to fully quantify, we anticipate that very few advisers would face a burden that exceeds 10 times the minimum estimate.<sup>1508</sup> Multiplying minimum initial cost estimates by 10 yields a maximum initial cost of \$2,243,689.20 per adviser. These costs are likely to be higher initially than they are ongoing. We estimate maximum ongoing costs will likely be one third of the initial costs, or \$747,896.40 per year.

The aggregate costs to the industry will depend on the proportion of advisers who pursue compliance via the required disclosures and the proportion of advisers who pursue compliance by forgoing the restricted activity. We believe that, in general, almost all advisers will pursue compliance with the final rule via disclosures as opposed to by ceasing the restricted activity.<sup>1509</sup> We therefore believe that the aggregate costs to the industry associated with this component of the final rule will likely be consistent with the aggregate costs to the industry as reflected in the PRA analysis. This is supported by the fact that the costs we estimate to each adviser of complying with the final rules by ceasing the restricted activity (in particular, potentially as high

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<sup>1507</sup> As discussed above, to the extent the proportion of initial costs that persist as ongoing costs is higher than one third, the ongoing costs would be proportionally higher than what is reflected here. *See supra* footnote 1456.

<sup>1508</sup> As discussed above, based on staff experience, as advisers grow in size, efficiencies of scale may emerge that limit the upper range of compliance costs. *See supra* footnote 1457.

<sup>1509</sup> *See infra* section VII.D.

as \$2,243,689.20 in initial costs) is much higher than the PRA cost per adviser across all restricted activities (\$54,768). However, to the extent that more than a *de minimis* number of advisers pursue compliance through ceasing the restricted activity instead of via disclosures, aggregate costs may be higher.<sup>1510</sup>

The lack of legacy status for this rule provision means that these costs will be borne across all private funds and advisers who currently engage in non pro-rata allocations of fees and expenses. Because such allocations are more common for private equity funds and other illiquid funds,<sup>1511</sup> these costs will generally be more applicable to advisers and investors in those funds.<sup>1512</sup>

### *Borrowing*

The final rule restricts an adviser, directly or indirectly, from borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client, unless it satisfies certain disclosure requirements and consent requirements.<sup>1513</sup>

In the Proposing Release we stated that in cases where, as the Commission has observed, fund assets were used to address personal financial issues of one of the adviser's principals, used to pay for the advisory firm's expenses, or used in association with any other harmful conflict of interest,<sup>1514</sup> then a prohibition would increase the amount of fund resources available to further

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<sup>1510</sup> See *infra* footnote 1533.

<sup>1511</sup> See *supra* sections II.E.1.c), VI.C.2.

<sup>1512</sup> However, there do not exist reliable data for quantifying precisely what percentage of private fund advisers today engage in this activity or the other restricted activities. For the purposes of quantifying costs, including aggregate costs, we have applied the estimated costs per adviser to all advisers in the scope of the rule, consistent with the approach taken in the PRA analysis. See *supra* section VII.

<sup>1513</sup> See *supra* section II.E.2.b).

<sup>1514</sup> *Id.*

the fund's investment strategy.<sup>1515</sup> We stated further that investors would benefit from any resulting increased payout and that investors would benefit from the elimination or reduction of any need to engage in costly research or negotiations with the adviser to prevent the uses of fund resources by the adviser that would be prohibited.<sup>1516</sup> We lastly stated that a prohibition would potentially benefit investors by reducing moral hazard: if an adviser borrows from a private fund client and does not pay back the loan, it is the investors who bear the cost, providing the adviser with incentives to engage in potentially excessive borrowing.<sup>1517</sup>

Some commenters agreed that a prohibition would generate benefits,<sup>1518</sup> but other commenters opposed the proposal,<sup>1519</sup> and one stated that benefits from such a prohibition would be *de minimis* because advisers and their related persons rarely borrow from fund clients.<sup>1520</sup> Because we have revised the final rule to allow for an exception should the adviser satisfy certain disclosure requirements and consent requirements, we believe the final rule will primarily generate benefits by allowing investors to more easily monitor instances where the adviser does borrow from the fund. Investors will benefit from the reduced cost of monitoring adviser borrowing activity, and from reduced risk of harm from the potential conflicts of interest or other harms we have identified above. Further benefits may accrue to investors in the case of advisers who would have otherwise borrowed from the fund forgo doing so, either voluntarily to avoid the cost of disclosure and the cost of consent requirements or in a follow-on fund where investors used the enhanced disclosure and consent requirements in the prior fund to negotiate such terms.

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<sup>1515</sup> Proposing Release, *supra* footnote 3, at 241.

<sup>1516</sup> *Id.*

<sup>1517</sup> *Id.*

<sup>1518</sup> See, e.g., OPERS Comment Letter; AFL-CIO Comment Letter; Convergence Comment Letter.

<sup>1519</sup> SIFMA-AMG Comment Letter I; NYC Bar Comment Letter II; IAA Comment Letter II.

<sup>1520</sup> NYC Bar Comment Letter II.

The disclosures and consent requirements may enhance investor negotiating positions because, as discussed above, many investors report that they accept poor terms because they do not know what is “market.”<sup>1521</sup> These additional benefits include increased fund resources available to further the fund’s investment strategy, increased payouts, the elimination or reduction of any need to engage in costly research or negotiations with the adviser to prevent the uses of fund resources, and reducing moral hazard. We are providing legacy status for the restriction on adviser borrowing, as the restriction requires investor consent.<sup>1522</sup> This legacy status will mitigate the benefits to current funds and investors who borrow from their funds, but will also reduce costs for those advisers.<sup>1523</sup> However, as discussed above we understand this practice is generally rare.<sup>1524</sup>

Similar to the restricted activities rule for certain fees and expenses, we believe that the risks to investors where advisers borrow against the fund motivate greater investor protections than is provided for in the case of the final rule restricting certain fees and expenses and clawbacks (and, similarly, the other types of preferential terms that must be disclosed but are not prohibited). Because the adviser borrowing from the fund is at a greater risk of being explicitly in the adviser’s interest at the expense of the fund’s interest, investors will benefit from the adviser being required to satisfy the necessary consent requirements. Moreover, because the adviser borrowing from the fund is less associated with the adviser benefiting certain advantaged investors at the expense of disadvantaged investors, the benefits are preserved by only requiring

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<sup>1521</sup> See *supra* section VI.B.

<sup>1522</sup> See *supra* section IV.

<sup>1523</sup> There do not exist reliable data for quantifying what percentage of private fund advisers today engage in this activity or the other restricted activities. For the purposes of quantifying costs, including aggregate costs, we have applied the estimated costs per adviser to all advisers in the scope of the rule, consistent with the approach taken in the PRA analysis. See *supra* section VII.

<sup>1524</sup> See *supra* section II.E.2.b).



at least a majority in interest of investors that are not related persons of the adviser. As a final matter, as discussed above there is a reduced risk of this conflict of interest distorting the terms, price, or interest rate of the fund's loan to the adviser, because the fund's investors can, if the borrow is disclosed and investor consent is sought, compare the terms of the loan to publicly available commercial rates to determine if the terms are appropriate given market conditions.<sup>1525</sup> As such the benefits are preserved without a need for a stricter policy choice than consent requirements.

Advisers who currently borrow from their funds will experience costs as a result of this rule from updating their practices to bring them into compliance with the new requirements, in particular by making the required new disclosures and by obtaining new consent. Advisers who cease borrowing from their funds, either voluntarily to avoid the cost of disclosure or in a follow-on fund where investors used the enhanced disclosure in the prior fund to negotiate such terms, may also face direct compliance costs associated with updating their business practices and fund documents to remove the ability of the adviser to borrow from the fund.

In the case where advisers comply with the final rule by making the required disclosures and by obtaining the required investor consent, costs are quantified by examination of the analysis in section VII, which have been tallied along with all other disclosure costs of the restricted activities above and include time needed for advisers to make the determination that the requisite disclosure is the appropriate path to compliance for that adviser.<sup>1526</sup>

However, advisers may instead face direct costs associated with the need to update their borrowing practices to bring them into compliance with the new requirements, in particular in

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<sup>1525</sup> See *supra* section VI.C.2.

<sup>1526</sup> See *supra* footnote 1450 and accompanying text.

the case where advisers cease borrowing from their funds instead of making the required disclosures and obtaining the required consent. As discussed in the Proposing Release, several factors make the quantification of these costs difficult, such as a lack of data on the extent to which advisers borrow from their funds today.<sup>1527</sup> However, one commenter criticized the Commission for acknowledging these direct costs but failing to quantify them.<sup>1528</sup> In light of this, the Commission has further considered the requirement and additional work that would be required by various parties to comply. To that end, the Commission has estimated ranges of costs for compliance, depending on the amount of time each adviser will need to spend to comply. Some advisers may pass these direct costs on to their funds and thus investors, and other advisers may absorb these costs and bear the costs themselves.

Advisers are likely to vary in the complexity of their contracts and borrowing practices, because for example some advisers may already refrain from ever borrowing from their funds. At minimum, we estimate that the additional work will require time from accounting managers (\$337/hour), compliance managers (\$360/hour), a chief compliance officer (\$618/hour), attorneys (\$484/hour), assistant general counsel (\$543/hour), junior business analysts (\$204/hour), financial reporting managers (\$339), senior business analysts (\$320/hour), paralegals (\$253/hour), senior operations managers (\$425/hour), operations specialists (\$159/hour), compliance clerks (\$82/hour), and general clerks (\$73/hour).<sup>1529</sup> Certain advisers may need to hire additional personnel to meet these demands. We also include time needed for advisers to make the determination that ceasing the restricted activity instead of making a

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<sup>1527</sup> Proposing Release, *supra* footnote 3, at 233-234.

<sup>1528</sup> Overdahl Comment Letter.

<sup>1529</sup> See *infra* section VII.

disclosure and obtaining consent is the appropriate path to compliance for that adviser, which we estimate will require time from senior portfolio managers (\$383/hour) and senior management of the adviser (\$4,770/hour).

To estimate monetized costs to advisers, we multiply the hourly rates above by estimated hours per professional. Based on staff experience, we estimate that on average, advisers will require at minimum 24 hours of time from each of the personnel identified above as an initial burden.<sup>1530</sup> For example, at minimum, each adviser may require time from these personnel to at least evaluate whether any revisions to their contracts are warranted at all. Multiplying these minimum hours by the above hourly wages yields a minimum initial cost of \$224,368.92 per adviser. These costs are likely to be higher initially than they are ongoing. We estimate minimum ongoing costs will likely be one third of the initial costs, or \$74,789.64 per year.<sup>1531</sup>

However, many of these potential direct costs of updates may be higher for certain advisers. Larger advisers, with more complex contracts and borrowing arrangements that are more complex to update, may have greater costs. Advisers may also vary in which investors consent to advisers' borrowing activities. While the factors that may increase these costs are difficult to fully quantify, we anticipate that very few advisers would face a burden that exceeds 10 times the minimum estimate. Multiplying minimum initial cost estimates by 10 wages yields a maximum initial cost of \$2,243,689.20 per adviser. These costs are likely to be higher initially than they are ongoing. We estimate maximum ongoing costs will likely be one third of the initial costs, or \$747,896.40 per year.

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<sup>1530</sup> As discussed above, this yields a total of 360 hours of personnel time for each of the restricted activities. *See supra* footnote 1455.

<sup>1531</sup> As discussed above, to the extent the proportion of initial costs that persist as ongoing costs is higher than one third, the ongoing costs would be proportionally higher than what is reflected here. *See supra* footnote 1456.

The aggregate costs to the industry will depend on the proportion of advisers who pursue compliance via the required disclosures and the required consent and the proportion of advisers who pursue compliance by forgoing the restricted activities. We believe that, in general, almost all advisers will pursue compliance with the final rule via disclosures and consent as opposed to by ceasing the required activities.<sup>1532</sup> We therefore believe that the aggregate costs to the industry associated with this component of the final rule will likely be consistent with the aggregate costs to the industry as reflected in the PRA analysis. This is supported by the fact that the costs we estimate to each adviser of complying with the final rules by ceasing the restricted activity (in particular, potentially as high as \$2,243,689.20 in initial costs) is much higher than the PRA cost per adviser across all restricted activities (\$54,768).

However, to the extent that more than a *de minimis* number of advisers pursue compliance through ceasing the restricted activity instead of via disclosures and consent, aggregate costs may be higher. For example, suppose five percent of private fund advisers (excluding advisers to solely securitized asset funds, or 612 advisers, pursue compliance through ceasing the restricted activities. Then maximum aggregate ongoing annual costs will in that case be \$2,234,128,277.2 as compared to aggregate PRA costs for restricted activities of \$592,285,120.<sup>1533</sup>

Other commenters who discussed the costs of the proposed rule primarily stated that the costs of the rule would be indirect, in that the proposed rule would have prohibited activity that

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<sup>1532</sup> See *infra* section VII.D.

<sup>1533</sup> We assume all 612 would be drawn from the pool of advisers who would have faced external PRA costs had they pursued compliance via the required disclosures and the required consent. Then 612 advisers will face ongoing costs of 4\*(\$747,896.40). The PRA assumes that 75% of advisers will face internal costs only, and not require any external burden, yielding 9,176 advisers facing ongoing costs of \$29,344. The PRA assumes 25% of advisers will face a further \$25,424 in external costs, yielding 2,447 advisers facing ongoing costs of \$54,768. See *infra* section VII.D.

could benefit investors, such as tax advances, borrowing arrangements outside of the fund structure, an adviser purchasing securities from a client under section 206(3) of the Advisers Act, and the activity of large financial institutions that play many roles in a private fund complex.<sup>1534</sup> We believe the final rule substantially eliminates these indirect costs by providing for an exception for certain disclosures and consent, as advisers are still permitted to conduct activities that could benefit investors so long as the required disclosures are made and the required investor consent is obtained.<sup>1535</sup> However, to the extent advisers forgo these activities because of the costs of disclosure, that will be an indirect cost of the rule. Advisers who cease borrowing from their funds may also face costs related to any marginal increases in the cost of capital incurred from new sources of borrowing, as compared to what was being charged by the fund.

#### **4. Preferential Treatment**

##### *Prohibition of Certain Preferential Terms*

The final rules will, as proposed, prohibit a private fund adviser from providing certain preferential terms to some investors that the adviser reasonably expects to have a material negative effect on other investors in the private fund or in a similar pool of assets,<sup>1536</sup> but in response to commenters contains three modifications. First, we are modifying the proposed term “substantially similar pool of assets” as used throughout the preferential treatment rule and changing it to “similar pool of assets.”<sup>1537</sup> Second, the rule will allow two exceptions from the

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<sup>1534</sup> See *supra* section II.E.2.b); see also SBAI Comment Letter; CFA Comment Letter I; AIC Comment Letter I; SIFMA-AMG Comment Letter I.

<sup>1535</sup> However, to the extent that a borrowing under the final rule also involves a purchase under section 206(3) of the Advisers Act, the requirements of that section will continue to apply to the adviser. The final rules may therefore result in additional direct costs as a result of requirements from both section 206(3) of the Advisers Act and the final restricted activities rule. See *supra* section II.E.2.b); SIFMA-AMG Comment Letter I.

<sup>1536</sup> See *supra* section II.F.

<sup>1537</sup> *Id.*

prohibition of preferential redemption terms: one for redemptions that are required by applicable law and another if the adviser offers the same redemption ability to all existing and future investors in the same private fund or any similar pool of assets.<sup>1538</sup> Lastly, the rule will also allow an exception from the prohibition on preferential information where the adviser offers the information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time.<sup>1539</sup>

Benefits may accrue from these prohibitions in two situations. First, we associate these practices with a tendency towards opportunistic hold-up of investors by advisers or the investors receiving the preferential treatment, involving the exploitation of an informational or bargaining advantage by the adviser or advantaged investor.<sup>1540</sup> The prohibitions may benefit the non-preferred investors in situations where advisers lack the ability to commit to avoid the opportunistic behavior after entering into the agreement (or relationship) with the investor. For example, similar to the case regarding non-pro rata fee and expense allocations, an adviser with repeat business from a large investor with early redemption rights and smaller investors with no early redemption rights may have adverse incentives to take on extra risk, as the adviser's preferred investor could exercise its early redemption rights to avoid the bulk of losses in the event an investment begins to fail. The adviser would then continue to receive repeat business

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<sup>1538</sup> *Id.*

<sup>1539</sup> *Id.* Because the rule will not apply to advisers with respect to CLOs and other SAFs they advise, there will be no benefits or costs for investors and advisers associated with those funds. However, unlike investors in other private funds, the noteholders are similarly situated with all of the other noteholders in the same tranche and they cannot redeem or "cash in" their note ahead of other noteholders in the same tranche. As a result, in our experience, this structure has generally deterred investors from requesting, and SAF advisers from granting, preferential treatment, especially preferential treatment that would have a material, negative effect on other investors, such as early redemption rights. We therefore understand the forgone benefits from this limitation in scope to be minimal. *See supra* section II.A.

<sup>1540</sup> *See supra* section II.F.

with the investors with preferential terms, to the detriment of the investors with no preferential terms.

Investors who do receive preferential terms may also receive information over the course of a fund's life that the investors can use to their own gain but to the detriment of the fund and, by extension, the other investors. With respect to preferential redemption rights, if a fund was heavily invested in a particular sector and an investor with early redemption rights learned the sector was expected to suffer deterioration, that investor has a first-mover advantage and could submit a redemption request, securing its funds early but forcing the fund to sell assets in a declining market, harming the other investors in three possible ways. First, if the fund sells a portion of a profitable or valuable asset to satisfy the redemption, the remaining investors' interests in that valuable asset is diluted. Second, if the fund is forced to sell a portion of an illiquid asset in a declining market, the forced sale could further depress the value of the asset, reducing the remaining investors' interests in the asset. Third, the remaining investors may have an impaired ability to successfully redeem their own interests after the first mover's redemption. In these situations, the prohibitions would provide a solution to the hold-up problem that is not currently available. The rule will benefit the disadvantaged investors by prohibiting such a situation, and so the disadvantaged investors would be less susceptible to hold-up and experience either less dilution on their fund investments or potentially greater valuations on certain illiquid assets, and potentially enhanced abilities to redeem without impairment from the preferred investors' first-mover advantage, as benefits of the final rule.

With respect to preferential information rights, we believe a similar situation could occur. If a fund were heavily invested in a particular sector and an investor with any redemption rights at all received preferential information that the sector was expected to suffer deterioration, that

investor could submit a redemption request, securing its funds early but forcing the fund to sell assets in a declining market, again harming the other investors similar to the above scenarios. In these situations, the prohibitions would provide a solution to the hold-up problem that is not currently available. The Commission has recognized these potential problems in past rulemakings.<sup>1541</sup> Specifically, the Commission has recognized that when selective disclosure leads to trading by the recipients of the disclosure the practice bears a close resemblance to ordinary insider trading.<sup>1542</sup> The economic effects of the two practices are essentially the same; in both cases, a few persons gain an informational edge -- and use that edge to profit at the expense of the uninformed -- from superior access to corporate insiders, not through skill or diligence.<sup>1543</sup> Thus, investors in many instances equate the practice of selective disclosure with insider trading. The Commission has also stated that the effect of selective disclosure is that individual investors lose confidence in the integrity of the markets because they perceive that certain market participants have an unfair advantage.<sup>1544</sup>

As discussed above, commenters argued that the use of preferential information to exercise redemption is an important element of determining whether providing information would have a material, negative effect on other investors and thus whether an adviser triggers the preferential information prohibition.<sup>1545</sup> We would generally not view preferential information rights provided to one or more investors in a closed-end/illiquid private fund as having a

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<sup>1541</sup> See *supra* section II.G.2.

<sup>1542</sup> See Selective Disclosure and Insider Trading, Securities Act Release, *supra* footnote 842.

<sup>1543</sup> *Id.*

<sup>1544</sup> *Id.* See also *infra* section VI.E.

<sup>1545</sup> See *supra* section II.G. See also, e.g., NY State Comptroller Comment Letter; Top Tier Comment Letter. We emphasize, however, that this potential for harm does not require the investor to have preferential redemption rights also. Preferential information combined with any redemption rights at all may result in harm to other investors.



material, negative effect on other investors.<sup>1546</sup> However, there may be cases where preferential information may be reasonably expected to have a material, negative effect on other investors in the fund even when the preferred investor does not have the ability to redeem its interest in the fund, and so whether preferential information violates the final rule requires a facts and circumstances analyses.<sup>1547</sup> For example, a private fund may invest in an asset with certain trading restrictions, and then later receive notice that the investment is performing poorly. If the private fund gives that information to a preferred investor before others, the preferred investor could front-run other investors in taking a (possibly synthetic) short position against the asset, driving its price down and causing losses to other investors in the fund. An adviser could also operate multiple funds with overlapping investments but offer redemption rights only for one fund containing its preferred investors. An adviser granting preferential information to certain investors in its less liquid fund, which those preferred investors could use to redeem their interests in the more liquid fund, could harm the investors in the less liquid fund even though the preferred investors do not have redemption rights in the less liquid fund.<sup>1548</sup>

Second, in situations where investors face uncertainty as to whether the adviser engages in the prohibited practice, the benefit from the prohibition would be to eliminate the costs to investors of avoiding entering into agreements with advisers that engage in the practice and the costs to investors from inadvertently entering into such agreements.

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<sup>1546</sup> *Id.*

<sup>1547</sup> *See supra* sections II.G, II.F.

<sup>1548</sup> For a similar scenario, *see, e.g.*, In the Matter of Alliance Capital Mgmt., L.P., Investment Advisers Act Release No. 2205 (Dec. 18, 2003) (settled order) (alleging Alliance Capital violated, among other things, Advisers Act rule against misuse of material non-public information by providing market timer with real-time non-public mutual fund portfolio information, enabling the timer to profit from synthetic short positions).

Specifically, in this second case, the prohibited preferential terms would harm investors in private funds and cause investors to incur extra costs of researching fund investments to avoid fund investments in which the prospective fund adviser engages in these practices (or costs of otherwise avoiding or mitigating the harm to those disadvantaged investors from the practice). The benefit of the prohibition to investors will be to eliminate such costs. It will prohibit disparities in treatment of different investors in similar pools of assets in the case where the disparity is due to the adviser placing their own interests ahead of the client's interests or due to behavior that may be deceptive. Investors will benefit from the costs savings of no longer needing to evaluate whether the adviser engages in such practices. Investors and advisers also may benefit from reduced cost of negotiating the terms of a fund investment. Investors who would have otherwise been harmed by the prohibited practices will benefit from the elimination of such harms through their prohibition. While many commenters from adviser groups and from large investors disputed these benefits,<sup>1549</sup> other commenters supported the view of these benefits.<sup>1550</sup>

These benefits, in particular the benefits from the prohibition on preferential redemption rights, may be mitigated by the two new exceptions to the rule allowed for in the final rule. Specifically, investors in private funds where other investors receive preferential redemption rights required by applicable law will not benefit from any prohibition. However, those investors will still benefit from enhanced disclosures of those preferential terms.<sup>1551</sup> We generally do not believe that benefits will be mitigated by the exception allowing for preferential redemption

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<sup>1549</sup> See, e.g., SBAI Comment Letter; MFA Comment Letter I.

<sup>1550</sup> See, e.g., ICCR Comment Letter; United for Respect Comment Letter I; Segal Marco Comment Letter.

<sup>1551</sup> See *supra* section II.F; see also *infra* section VI.D.4.

rights or preferential information granted to other investors so long as those rights and information are offered to all existing and future investors, because an adviser is prohibited from doing indirectly what it cannot do directly and an adviser must offer investors options with reasonably the same incentives.<sup>1552</sup> For example, an adviser could not avail itself of the exception by offering Class A (quarterly redemption, 1.5% management fee, 20% performance fee) and Class B (annual redemption, 1% management fee, 15% performance fee) while requiring Class B investors to also invest in another fund managed by the adviser.<sup>1553</sup> While we do not believe any such menus of share classes offered to all investors will generally result in the types of harm we have considered above, at the margin there may be cases in which investors do not realize the implications of the share classes being offered to them, and select differential redemption rights that lead to eventual harm. These cases, to the extent they occur, would reduce the benefits of the final rules.

The benefits of the prohibition on preferential redemption rights may generally be lessened for investors in funds managed by ERAs relying on the venture capital exemption, because such venture capital funds must prohibit investor redemptions except in extraordinary circumstances to qualify for the registration exemption.<sup>1554</sup> However, there may still be meaningful benefits from this prohibition for those investors to the extent that “extraordinary circumstances” are exactly the circumstances where preferential redemptions for certain investors are most likely to have a material, negative effect on other investors in the fund.

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<sup>1552</sup> See *supra* section II.F; see also section 208(d) of the Advisers Act.

<sup>1553</sup> *Id.*

<sup>1554</sup> See *supra* section VI.C.1.

The cost of the prohibitions will depend on the extent to which investors would otherwise obtain such preferential terms in their agreements with advisers and the conditions under which they make use of the preferential treatment. Investors who would have obtained and made use of the preferential terms will incur a cost of losing the prohibited redemption and information rights. This will include any investors who might benefit from the ability to redeem based on negotiated exceptions to the private fund's stated redemption terms, in addition to the investors who might benefit from the hold-up problems discussed above.

Commenters also expressed concerns that both investors and advisers may face costs in the case of smaller funds who rely on offering preferential treatment to anchor or seed investors, including preferential redemption terms that will be prohibited under the final rules that prohibit preferential terms to some investors that the adviser reasonably expects to have a material negative effect on other investors in the private fund or in a similar pool of assets.<sup>1555</sup> However, because advisers are only prevented from offering anchor investors preferential redemption rights and preferential information that the adviser reasonably expects will have a material negative effect on other investors these potential harms to competition will be mitigated to the extent that smaller, emerging advisers do not need to be able to offer anchor investors preferential rights that the adviser reasonably expects to have a material negative effect on other investors to effectively compete, and to the extent that smaller emerging advisers are able to compete effectively by offering anchor investors other types of preferential terms that will not materially negatively affect other investors. However, some smaller or emerging advisers may

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<sup>1555</sup> Commenters also state that smaller emerging advisers may close their funds in response to the final rules and their resulting restricted ability to offer certain preferential terms to anchor investors. We discuss these effects of the final rules on competition below. *See infra* section VI.E; *see also, e.g.*, Carta Comment Letter; Meketa Comment Letter; Lockstep Ventures Comment Letter; NY State Comptroller Comment Letter; Weiss Comment Letter; AIC Comment Letter I; AIC Comment Letter I, Appendix 2; MFA Comment Letter II.

find it more difficult to compete without offering preferential redemption rights or preferential information that will now be prohibited.

To the extent advisers respond to the prohibitions on certain preferential redemption rights and preferential information by developing new preferential terms and disclosing them to all investors, there may be new potential harms to investors who do not receive these new preferential terms. For example, advisers may offer greater fee breaks to anchor or seed investors instead of the prohibited terms and may accordingly charge higher fees to non-preferred investors.

In addition, advisers will incur direct costs of updating their processes for entering into agreements with investors, to accommodate what terms could be effectively offered to all investors once the option of preferential terms to certain investors has been removed. These direct costs may be particularly high in the short term to the extent that advisers renegotiate, restructure and/or revise certain existing deals or existing economic arrangements in response to this prohibition. However, because such deals will have legacy status under the rule and will therefore not require a restructuring under the rules,<sup>1556</sup> we expect that these renegotiations or restructurings will typically only occur to the extent that they represent a net positive benefit to investors who successfully renegotiate new terms by threatening to move their investments to new funds that do not offer any investors the prohibited preferential redemption rights or prohibited preferential information.

The costs of the prohibition on preferential redemption rights are mitigated by the two exceptions adopted in the final rule: for redemption rights that are required by applicable law and redemption rights where the adviser offers the same redemption ability to all existing and future

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<sup>1556</sup> See *supra* section IV.

investors, there will be limited new compliance costs, and the investors who currently benefit from such terms will continue to do so, in a change from the proposal's costs.<sup>1557</sup>

As discussed in the Proposing Release, several factors make the quantification of these costs difficult, such as a lack of data on the extent to which advisers currently offer preferential terms that will be prohibited under the final rule.<sup>1558</sup> However, one commenter criticized the Commission for failing to quantify these costs.<sup>1559</sup> In light of this, the Commission has further considered the requirement and additional work that would be required by various parties to comply. To that end, the Commission has estimated ranges of costs for compliance, depending on the amount of time each adviser will need to spend to comply.

We estimate a range of costs because advisers are likely to vary in the complexity of their contractual arrangements, because for example some advisers may not offer any preferential terms today that will be prohibited. At minimum, we estimate that the additional work will require time from accounting managers (\$337/hour), compliance managers (\$360/hour), a chief compliance officer (\$618/hour), attorneys (\$484/hour), assistant general counsel (\$543/hour), junior business analysts (\$204/hour), financial reporting managers (\$339), senior business analysts (\$320/hour), paralegals (\$253/hour), senior operations managers (\$425/hour), operations specialists (\$159/hour), compliance clerks (\$82/hour), and general clerks (\$73/hour).<sup>1560</sup> Certain advisers may need to hire additional personnel to meet these demands. Given the impact of

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<sup>1557</sup> See *supra* section II.F. The burden associated with the preparation, provision, and distribution of written notices for advisers who comply with the rule by (i) offering the same preferential redemption terms to all existing and future investors and (ii) offering the same preferential information to all other investors, in each case, in accordance with the exceptions to the prohibitions aspect of the final rule, is included in the PRA analysis. See *infra* section VII.

<sup>1558</sup> Proposing Release, *supra* footnote 3, at 233-234.

<sup>1559</sup> AIC Comment Letter I, Appendix 2.

<sup>1560</sup> See *infra* section VII.

preferential treatment decisions on fund capital and business outcomes, we also include time needed from senior portfolio managers (\$383/hour) and senior management of the adviser (\$4,770/hour).

To estimate monetized costs to advisers, we multiply the hourly rates above by estimated hours per professional. To estimate the minimum number of hours required, we consider the minimum amount of burden that may result from the prohibitions on certain preferential redemption rights and certain preferential information. We expect most advisers will also only face direct costs of updating their contracts for new funds, and therefore the minimum costs in the estimated range do not include direct costs for renegotiating or restructuring contracts for existing funds. Each adviser will also require a minimum amount of time from these personnel to at least evaluate whether any revisions to their contracts are warranted at all. Based on staff experience, we estimate that on average, advisers will require at minimum 72 hours of time from each of the personnel identified above as an initial burden. Multiplying these minimum hours by the above hourly wages yields a minimum initial cost of \$673,106.76 per adviser. These costs are likely to be higher initially than they are ongoing. We estimate minimum ongoing costs will likely be one third of the initial costs, or \$224,368.92 per year.<sup>1561</sup>

However, many of these potential direct costs of updates may be higher for certain advisers. Larger advisers, with more complex contractual arrangements that are more complex to update, may have greater costs. Some advisers may also need to restructure or renegotiate contracts for existing funds, in response to pressure from investors resulting from the final rules,

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<sup>1561</sup> As discussed above, to the extent the proportion of initial costs that persist as ongoing costs is higher than one third, the ongoing costs would be proportionally higher than what is reflected here. *See supra* footnote 1456.

despite the legacy status.<sup>1562</sup> While the factors that may increase these costs are difficult to fully quantify, we anticipate that very few advisers would face a burden that exceeds 10 times the minimum estimate.<sup>1563</sup> Multiplying minimum initial cost estimates by 10 yields a maximum initial cost of \$6,731,067.60 per adviser. These costs are likely to be higher initially than they are ongoing. Based on staff experience, we estimate maximum ongoing costs will likely be one third of the initial costs, or \$2,243,689.20 per year.

In addition to compliance costs, some commenters stated that the prohibition on preferential information may have an unintended chilling effect on ordinary investor communications and will impede the co-investment process.<sup>1564</sup> To the extent there are ordinary communications that are valued by investors that would have occurred absent this rule, and those communications do not occur under the rule, the loss of those valued communications represents a cost of the rule. This may include advisers interpreting the rule as prohibiting selective disclosure of portfolio information to investors in co-investment vehicles.<sup>1565</sup> Similarly, certain commenters expressed concerns at ambiguity around the meaning of “material, negative effect.”<sup>1566</sup> When industry participants view terms such as these as ambiguous, this increases the risk identified by commenters of some advisers evaluating their meaning broadly and providing less information to investors.

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<sup>1562</sup> See *supra* footnote 1556 and accompanying text.

<sup>1563</sup> As discussed above, based on staff experience, as advisers grow in size, efficiencies of scale may emerge that limit the upper range of compliance costs. See *supra* footnote 1457.

<sup>1564</sup> See, e.g., MFA Comment Letter I; Haynes & Boone Comment Letter; Dechert Comment Letter; RFG Comment Letter II; AIMA/ACC Comment Letter; AIC Comment Letter I, Appendix 1; Segal Marco Comment Letter.

<sup>1565</sup> See AIC Comment Letter I; Segal Marco Comment Letter.

<sup>1566</sup> See, e.g., ILPA Comment Letter I; RFG Comment Letter II; AIMA/ACC Comment Letter; Schulte Comment Letter; SFA Comment Letter II.



Certain elements of the prohibition may result in these types of costs. For example, the application of the prohibition to all forms of communication, both formal and informal, may drive certain advisers to conservatively evaluate what information can be provided on a preferential basis.<sup>1567</sup> However, we also believe that the scope of the prohibition is reasonably precisely defined, such that the risk of advisers conservatively evaluating the prohibition and denying ordinary investor communications may be low. The prohibition only applies in a narrow set of circumstances: when the adviser reasonably expects that providing information would have a material, negative effect on other investors in the private fund or similar pool of assets. We believe advisers will in general be able to form reasonable expectations around what types of information are likely to have a material, negative effect on other investors, for example by examining the effect of delivering comparable information to investors in the past, either in their own prior funds, other funds in public press, or other funds in Commission enforcement actions.<sup>1568</sup> Moreover, once advisers begin disclosing what forms of preferential treatment they provide pursuant to the final preferential treatment rule, the reactions of other investors may give advisers a clearer, more comprehensive picture of when material, negative effects may result.<sup>1569</sup>

Any preferential information that does not meet the specified reasonable expectation of a material, negative effect criteria would only be subject to the disclosure portions of this rule.<sup>1570</sup>

We believe this also mitigates the risk of any unintended chilling of communication.

Because fund agreements entered into before the compliance date will have legacy status, benefits to investors will generally not accrue for current funds unless they are able to negotiate

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<sup>1567</sup> See *supra* section II.F.

<sup>1568</sup> *Id.*

<sup>1569</sup> *Id.*

<sup>1570</sup> See *supra* section II.F; see also final rule 211(h)(2)-3(b).

revised terms to their existing contracts, but benefits to investors in future funds will benefit from advisers ceasing prohibited preferential treatment activity. This will also generally be the case for costs of the final rules prohibiting a private fund adviser from providing certain preferential terms to some investors that the adviser reasonably expects to have a material negative effect on other investors in the private fund or in a similar pool of assets. However, investors in liquid funds who have the ability to redeem may do so in response to the final rules, if they do not currently receive preferential terms, to reallocate their investments into new private funds that are subject to the rules and do not offer preferential terms reasonably expected to have a material, negative effect on other investors. Those investors may be able to benefit from the final rules, and advisers correspondingly may face costs associated with reduced compensation from losing the assets of those investors.

*Prohibition of Other Preferential Treatment Without Disclosure*

The final rule also will prohibit other preferential terms unless the adviser provides certain written disclosures to prospective and current investors, and these disclosures must contain information regarding all preferential treatment the adviser provides to other investors in the same fund.<sup>1571</sup> In response to commenters, we are also adopting the prohibition of other preferential treatment without disclosure in a modified form. We are limiting the advance written notice requirement to prospective investors to only apply to material economic terms, but we are still requiring advisers to provide to current investors comprehensive disclosure of all preferential treatment. The timing of when that disclosure is provided will depend on whether

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<sup>1571</sup> See *supra* section II.F. Because the rule will not apply to advisers with respect to SAFs, there will be no benefits or costs for investors and advisers associated with those funds. See *supra* footnote 1539.

the fund is a liquid or illiquid fund. We are also adopting the annual written disclosure requirement as proposed.<sup>1572</sup>

This rule will reduce the risk of harm that some investors face from expected favoritism toward other investors, and help investors understand the scope of preferential terms granted to other investors, which could help investors shape the terms of their relationship with the adviser of the private fund. Because these disclosures would need to be provided to prospective investors prior to their investments and to current investors annually, these disclosures would help investors shape the terms of their relationship with the adviser of the private fund. This may lead the investor to request additional information on other benefits to be obtained, such as co-investment rights, and would allow an investor to understand better certain potential conflicts of interest and the risk of potential harms or other disadvantages.

Some commenters who supported the rule in general offered perspectives consistent with these benefits. In particular, as discussed above, many investors report that they accept poor legal terms in LPAs largely because they do not think that they have sufficient information on “what’s market” to be included in LPA terms.<sup>1573</sup> Other commenters more specifically stated that with better transparency into preferential treatment, investors would be able to better protect themselves from risks to their investments.<sup>1574</sup> Another commenter stated that the proposed rule would generally assist investors in the negotiation process.<sup>1575</sup>

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<sup>1572</sup> *Id.*

<sup>1573</sup> *See supra* section VI.B.

<sup>1574</sup> *See, e.g.*, Healthy Markets Comment Letter I; Trine Comment Letter; AFREF Comment Letter I; NEBF Comment Letter; NASAA Comment Letter; Segal Marco Comment Letter; Pathway Comment Letter.

<sup>1575</sup> RFG Comment Letter II.

Disclosures of such preferential treatment would impose direct costs on advisers to update their contracting and disclosure practices to bring them into compliance with the new requirements, including by incurring costs for legal services. These direct costs may be particularly high in the short term to the extent that advisers renegotiate, restructure and/or revise certain existing deals or existing economic arrangements in response to this prohibition. However, these costs may also be reduced by an adviser's choice between not providing the preferential terms and continuing to provide the preferential terms with the required disclosures, as the costs to some advisers from not providing the preferential terms to investors may be lower than the costs from the disclosure. Both the costs and the benefits may be mitigated to the extent that advisers already make the required disclosures, for example in response to any relevant State laws.<sup>1576</sup>

As discussed below, for purposes of the PRA, we anticipate that the total costs of making the required disclosures pursuant to the rule prohibiting preferential treatment without disclosure will impose an aggregate annual internal cost of \$364,386,264.48 and an aggregate annual external cost of \$41,475,520 for a total cost of \$405,861,784.48 annually.<sup>1577</sup> To the extent that advisers are not prohibited from categorizing all or a portion of these costs as expenses to be borne by the fund, then these costs may be borne indirectly by investors to the fund instead of advisers. We believe these costs are mitigated in part by the limiting of the final rules to only those terms that a prospective investor would find most important and that would significantly

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<sup>1576</sup> See *supra* section VI.C.2.

<sup>1577</sup> We have also adjusted these estimates to reflect that the final rule will not apply to SAF advisers with respect to SAFs they advise. See *infra* section VII.F. As explained in that section, this estimated annual cost is the sum of the estimated recurring cost of the proposed rule in addition to the estimated initial cost annualized over the first three years. As discussed above, one commenter criticized the quantification methods underlying these estimates, and we have explained why we do not agree with that criticism. See *supra* footnote 1366. Nevertheless, to reflect the commenter's concerns, and recognizing certain changes from the proposal, we are revising the estimates upwards as reflected here and in section VII.B.

impact its bargaining position (*i.e.*, material economic terms, including but not limited to the cost of investing, liquidity rights, investor-specific fee breaks, and co-investment rights).

However, private fund advisers, in addition to having to undertake direct compliance costs associated with their disclosures, may ultimately face direct costs as described by commenters associated with revising their business practices, policies, and procedures to ensure successful fund closings that are in compliance with the final rules.<sup>1578</sup> As discussed in the Proposing Release, several factors make the quantification of costs difficult, such as a lack of data on the extent to which advisers currently offer preferential terms that will be prohibited under the final rule unless the adviser makes certain disclosures.<sup>1579</sup> However, some commenters criticized the Commission for failing to quantify these costs.<sup>1580</sup> In light of this, and in light of commenter concerns on other direct costs to advisers associated with having to revise their business practices above and beyond making disclosures, the Commission has further considered the requirement and additional work that would be required by various parties to comply. To that end, the Commission has estimated ranges of costs for compliance, depending on the amount of time each adviser will need to spend to comply.

Advisers are likely to vary in the complexity of their contractual arrangements, because for example some advisers may not offer any preferential terms today that will be prohibited. At minimum, we estimate that the additional work will require time from accounting managers (\$337/hour), compliance managers (\$360/hour), a chief compliance officer (\$618/hour),

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<sup>1578</sup> While commenters' concerns were primarily focused on fund closing processes, hedge funds and other liquid funds that raise capital on an ongoing basis may face related additional costs associated with investors delaying investing in the fund in order to learn more about what terms are being received by other investors. However, for those funds, any incentive for investors to delay committing their capital will be at least partially offset by the fact that they will not earn the returns of the fund for the duration of their delay.

<sup>1579</sup> Proposing Release, *supra* footnote 3, at 233-234.

<sup>1580</sup> AIC Comment Letter I, Appendix 2; LSTA Comment Letter, Exhibit C.

attorneys (\$484/hour), assistant general counsel (\$543/hour), junior business analysts (\$204/hour), financial reporting managers (\$339), senior business analysts (\$320/hour), paralegals (\$253/hour), senior operations managers (\$425/hour), operations specialists (\$159/hour), compliance clerks (\$82/hour), and general clerks (\$73/hour).<sup>1581</sup> Certain advisers may need to hire additional personnel to meet these demands. Given the impact of preferential treatment decisions on fund capital and business outcomes, we also include time needed from senior portfolio managers (\$383/hour) and senior management of the adviser (\$4,770/hour).

To estimate monetized costs to advisers, we multiply the hourly rates above by estimated hours per professional. Based on staff experience, we estimate that on average, advisers will require at minimum 36 hours of time from each of the personnel identified above as an initial burden. For example, at minimum, each adviser may require time from these personnel to at least evaluate whether any revisions to their contracts are warranted at all. Multiplying these minimum hours by the above hourly wages yields a minimum initial cost of \$336,553.38 per adviser. These costs are likely to be higher initially than they are ongoing. Based on staff experience, we estimate minimum ongoing costs will likely be one fifth of the initial costs, or \$112,184.46 per year.<sup>1582</sup>

However, many of these potential direct costs of updates may be higher for certain advisers. Larger advisers, with more complex contracts and preferential treatment arrangements that are more complex to update, may have greater costs. While the factors that may increase these costs are difficult to fully quantify, we anticipate that very few advisers would face a

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<sup>1581</sup> See *infra* section VII.

<sup>1582</sup> As discussed above, to the extent the proportion of initial costs that persist as ongoing costs is higher than one third, the ongoing costs would be proportionally higher than what is reflected here. See *supra* footnote 1456.

burden that exceeds 10 times the minimum estimate.<sup>1583</sup> Multiplying minimum initial cost estimates by 10 yields a maximum initial cost of \$3,365,533.80 per adviser. These costs are likely to be higher initially than they are ongoing. Based on staff experience, we estimate maximum ongoing costs will likely be one third of the initial costs, or \$1,121,844.60 per year.

We believe the direct costs of the final rule will be equal to the sum of the PRA direct costs and non-PRA direct costs, as we believe the preferential treatment rule will in general require advisers to both undertake additional disclosures of preferential treatment offered to investors as well as revise their business practices, policies, and procedures. We do not believe that, in general, any advisers will come into compliance with the final rule by, for example, forgoing offering preferential treatment altogether, thereby avoiding all disclosures-based PRA costs.

In addition to these direct compliance costs, at the proposing stage, we stated that to the extent that these disclosures could discourage advisers from providing certain preferential terms in the interest of avoiding future negotiations with other investors on similar terms, this prohibition could ultimately decrease the likelihood that some investors are granted preferential terms.<sup>1584</sup> Commenters generally agreed, stating that these disclosures would discourage advisers from providing certain preferential terms in the interest of avoiding future negotiations with other investors on similar terms, or out of a conservative evaluation of their obligations under the rule and a resulting fear of non-compliance.<sup>1585</sup> As a result, some investors may find it harder to secure such terms.

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<sup>1583</sup> As discussed above, based on staff experience, as advisers grow in size, efficiencies of scale may emerge that limit the upper range of compliance costs. *See supra* footnote 1457.

<sup>1584</sup> Proposing Release, *supra* footnote 3, at 249.

<sup>1585</sup> *See, e.g.*, AIMA/ACC Comment Letter; OPERS Comment Letter.

Some commenters also stated that the prohibition on preferential treatment without disclosure would impede fund closing processes. Specifically, commenters stated that the Commission’s proposal would disadvantage investors that participate in earlier closings, as the investors in later closings would have access to an even larger set of disclosed agreements. This dynamic would provide investors with an incentive to wait—it encourages investors to try to be the last investor to sign up for a fund—making fundraising even more difficult and time consuming.<sup>1586</sup> Some commenters stated that because of the dynamic nature of negotiations leading up to a closing (*i.e.*, advisers simultaneously negotiate with multiple investors), it would be impractical for an adviser to provide advance written notice to a prospective investor because doing so would result in a repeated cycle of disclosure, discussion, and potential renegotiation.<sup>1587</sup>

While commenters may be correct that, at the margin, there may be certain increased difficulties associated with the fund closing process under the new rule, we believe there are two key factors mitigating any concern that the final rule will create any meaningful fund closing problems.

First, as discussed in the economic baseline, there already exists today an incentive for investors to wait for their latest possible opportunity to close, freeriding on the due diligence and resulting negotiated terms conducted by earlier investors,<sup>1588</sup> and therefore have already developed two tools for overcoming this problem, and will continue to have those tools available to them, namely (i) offering earlier investors MFN provisions to convince them to commit to the

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<sup>1586</sup> See, e.g., AIC Comment Letter I.

<sup>1587</sup> MFA Comment Letter I; PIFF Comment Letter; Chamber of Commerce Comment Letter; AIMA/ACC Comment Letter; Correlation Ventures Comment Letter; SIFMA-AMG Comment Letter I; ATR Comment Letter.

<sup>1588</sup> See *supra* section VI.C.2.



fund early, and (ii) an ability to cultivate a reputation that early investors will receive beneficial terms (such as reduced fees) that will not be granted to later investors.<sup>1589</sup> We believe both of these tools will continue to facilitate efficient fund closings under the final rule just as they do today.

Second, at least some portion of any increased difficulty in securing fund closings is likely to be because many advisers, having disclosed greater terms to prospective investors, now must compete more intensely to secure capital from those investors. In these cases, the increased operational difficulties for advisers are at least partially offset by the benefits of greater competition to investors.

The lack of legacy status for this rule provision means that these benefits will accrue across all private funds and advisers. This will also be the case for costs of the rule.

## **5. Mandatory Private Fund Adviser Audits**

The final audit rule will require an investment adviser that is registered or required to be registered to cause each private fund that it advises, directly or indirectly, to undergo audits in accordance with the audit provision under the custody rule.<sup>1590</sup> These audits will need to be performed by an independent public accountant that meets certain standards of independence and is registered with and subject to regular inspection by the PCAOB, and the statements will need to be prepared in accordance with generally accepted accounting principles as currently required under the custody rule.<sup>1591</sup> In a change from the proposal, the rule will not require that auditors notify the Commission in any circumstances.<sup>1592</sup> The lack of legacy status for this rule

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<sup>1589</sup> *Id.*

<sup>1590</sup> *See supra* section II.C.

<sup>1591</sup> *Id.*

<sup>1592</sup> *Id.*

provisions mean that the benefits and costs will apply across all investors in private funds and their advisers, not just new issuances.

We discuss the costs and benefits of this rule below. Several factors, however, make the quantification of many of the economic effects of the final amendments and rules difficult. For example, there is a lack of quantitative data on the extent to which auditors may raise their prices in response to new demand for audits. It would also be difficult to quantify how advisers may pass on any additional costs for audits in response to the final rule. As a result, parts of the discussion below are qualitative in nature.

### *Benefits*

We recognize that many advisers already provide audited fund financial statements to fund investors in connection with the adviser's alternative compliance with the custody rule.<sup>1593</sup> However, to the extent that an adviser does not currently have its private fund client undergo a financial statement audit, investors would receive more reliable information from private fund advisers as a result of the final audit rule. The benefits to investors will therefore vary across fund sizes, as smaller and larger funds have different propensities to already pursue audits.<sup>1594</sup> However, of course, because larger funds have more assets, these larger funds still represent a large volume of unaudited assets. Funds of size <\$10 million have approximately \$7.1 billion in assets not audited by a PCAOB-registered and -inspected independent auditor, while funds of size >\$500 million have approximately \$1.9 trillion in assets not audited by a PCAOB-registered and -inspected independent auditor.<sup>1595</sup>

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<sup>1593</sup> See *supra* section VI.C.4.

<sup>1594</sup> *Id.*

<sup>1595</sup> See *supra* section VI.C.4.

Because advisers to funds that an adviser does not control and that are neither controlled by nor under common control with the adviser (*e.g.*, where an unaffiliated sub-adviser provides services to the fund) have only a requirement to take all reasonable steps to cause their fund to undergo an audit that meets these elements,<sup>1596</sup> investors in those funds may not benefit from the final rules as frequently, to the extent that those funds' advisers' reasonable steps fail to cause their funds to undergo an audit. Similarly, the final mandatory audit rule will not require advisers to obtain audits of SAFs, investors in SAFs will not benefit from the final rules.<sup>1597</sup> However, commenters have stated that in the case of CLOs and other SAFs, there would be minimal benefit to investors from an audit, consistent with the fact that very few advisers to CLOs and other SAFs cause their funds to undergo an audit today compared to audit rates for other types of private funds.<sup>1598</sup> For example, one commenter stated that GAAP's efforts to assign, through accruals, a period to a given expense or income may not be useful, and potentially confusing, for SAF investors because principal, interest, and expenses of administration of assets can only be paid from cash received.<sup>1599</sup>

We further understand that agreed-upon procedures are a more common practice for these funds, and such procedures often relate to the securitized asset fund's cash flows and the calculations relating to a securitized asset fund portfolio's compliance with the portfolio requirements and quality tests (such as overcollateralization, diversification, interest coverage,

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<sup>1596</sup> See *supra* section II.C.

<sup>1597</sup> See *supra* section II.A.

<sup>1598</sup> See *supra* section VI.C.4. Approximately 10% of SAFs do get audits, from PCAOB-registered and -inspected independent auditors, of U.S. GAAP financial statements. *Id.* Advisers to these funds would not be prohibited from continuing to cause the fund to undergo such an audit of U.S. GAAP financial statements under the final rules.

<sup>1599</sup> *Id.*

and other tests) set forth in the fund's securitization transaction agreements.<sup>1600</sup> To the extent advisers to CLOs and other SAFs continue to undertake existing agreed-upon procedures practices, the forgone benefits from not applying the final rules to advisers with respect to their SAFs may be mitigated. However, audits provide stronger protections to investors than agreed-upon procedures, and so to the extent audits would benefit investors to SAFs, then there will still be forgone benefits from not applying the final rules to advisers with respect to their SAFs.

The audit requirement will provide an important check on the adviser's valuation of private fund assets, which often has an impact on the calculation of the adviser's fees. It may thereby limit some opportunities for advisers to materially over-value investments. Audits provide substantial benefits to private funds and their investors because audits also test other assertions associated with the investment portfolio that are not captured by surprise examinations, which only test the existence of assets: *e.g.*, audits test all relevant assertions such as completeness, and rights and obligations. Audits may also provide a check against adviser misrepresentations of performance, fees, and other information about the fund, for example by detecting irregularities or errors, as well as an investment adviser's loss, misappropriation, or misuse of client investments. Enhanced and standardized regular auditing may therefore broadly improve the completeness and accuracy of fund performance reporting, to the extent these audits improve fund valuations of their investments. Investors who are not currently provided with audited fund financial statements that meet the requirements of the final rule may, as a result, have additional beneficial information regarding their investments and, in turn, the fees being paid to advisers.

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<sup>1600</sup> *Id.*

However, audits do not perfectly prevent all forms of investor harm, and investor benefits can be mitigated to the extent that checks on valuation, even independent checks, are influenced by adviser behavior in a way that is not possible for audits to detect. For example, an adviser trading an illiquid asset between different funds owned by the adviser or the adviser’s related entities may bias data reported by independent pricing services, to the extent that the asset’s illiquidity causes the pricing service to overly weight the adviser’s own transactions in publishing an independent estimate of the asset’s price.<sup>1601</sup> These types of pricing distortions can be difficult for audits to detect and may therefore mitigate benefits of the final mandatory audit rule. To the extent investors over-assume the degree of protection offered by audits, and reduce their own monitoring or due diligence of adviser conduct, this may be a negative effect of the final audit rule.

As discussed above, currently not all financial statement audits of private funds are necessarily conducted by a PCAOB-registered independent public accountant that is subject to regular inspection.<sup>1602</sup> The requirement that the independent public accountant performing the audit be registered with, and subject to regular inspection by, the PCAOB, is likely to improve the audit and financial reporting quality of private funds.<sup>1603</sup> Higher quality audits generally

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<sup>1601</sup> See, e.g., In the Matter of Chatham Asset Mgmt., Investment Advisers Act Release No. 6270 (Apr. 3, 2023).

<sup>1602</sup> See *supra* section VI.C.4.

<sup>1603</sup> See, e.g., Daniel Aobdia, *The Impact of the PCAOB Individual Engagement Inspection Process—Preliminary Evidence*, 93 ACC. REV. 53-80 (2018) (concluding that “engagement-specific PCAOB inspections influence non-inspected engagements, with spillover effects detected at both partner and office levels” and that “the information communicated by the PCAOB to audit firms is applicable to non-inspected engagements”); Daniel Aobdia, *The Economic Consequences of Audit Firms’ Quality Control System Deficiencies*, 66 MGMT. SCI. (July 2020) (concluding that “common issues identified in PCAOB inspections of individual engagements can be generalized to the entire firm, despite the PCAOB claiming that its engagement selection process targets higher-risk clients” and that “[PCAOB quality control] remediation also appears to positively influence audit quality”). See also Safeguarding Release, *supra* footnote 467.

have a greater likelihood of detecting material misstatements due to fraud or error, and we further believe that investors will benefit more from the higher quality of audits conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.<sup>1604</sup> The requirement to distribute the audited financial statements to current investors annually within 120 days of the private fund’s fiscal year-end and promptly upon liquidation will allow investors to evaluate the audited financial information in a timely manner.

In a change from the proposal, investors will not receive potential benefits from any enhanced regulatory oversight that would have accrued as a result of the proposed requirement for the adviser to engage the auditor to notify the Commission under some conditions.<sup>1605</sup> While problems identified during a surprise examination must currently be reported to the Commission under the custody rule, problems identified during an audit, even if the audit is serving as the replacement for the surprise examination under the custody rule, will continue to not need to be reported to the Commission.<sup>1606</sup> Some commenters questioned the benefits of the notification provision,<sup>1607</sup> but other commenters supported the proposal,<sup>1608</sup> with one stating that the issuance of a modified opinion or the auditor’s termination may be “serious red flags that warrant early notice to regulators.”<sup>1609</sup>

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<sup>1604</sup> *Id.*

<sup>1605</sup> *See supra* section II.C.

<sup>1606</sup> *See supra* section VI.C.4. Recently, the SEC has proposed to amend and redesignate the custody rule. *See supra* VI.C.4; *see also* Safeguarding Release, *supra* footnote 467. Advisers that currently obtain surprise exams will likely cease doing so, to the extent they are duplicative of the mandatory audits, which may result in a reduction of any reporting to the Commission under the custody rule.

<sup>1607</sup> NYC Bar Comment Letter II; BVCA Comment Letter; Invest Europe Comment Letter.

<sup>1608</sup> NASAA Comment Letter; RFG Comment Letter II.

<sup>1609</sup> NASAA Comment Letter.

One commenter argued that audits do not provide benefits to private fund investors.<sup>1610</sup> That commenter cited two studies related to private equity and venture capital funds and argued that these studies show that there is only limited evidence that audits provide capital market benefits to funds and that audits do not improve fund's NAV estimates. We disagree with this commenter and continue to agree with the consensus view, established by the academic literature cited in the above discussion, that audits provide meaningful benefits to fund investors.

Moreover, a key focus on one study is estimating the impact of an audit on an adviser's ability to raise new funds.<sup>1611</sup> We do not believe that advisers to unaudited funds and advisers to audited funds having similar probabilities of raising new funds is necessarily in contrast to the value of audits. For example, oftentimes advisers raise new funds before exiting investments of prior funds. Fund exits require an actual transaction price which may differ from the adviser's fair value estimate. Part of the benefit of an audit is that asset valuation discrepancies may be more likely to be detected prior to an exit when the fund is audited, and therefore prior to when an adviser begins to raise a new fund. This author's results also do not engage with the market failures and economic rationale described above, such as investors having worse outside options to a given negotiation than the adviser, the investor's operational difficulties associated with switching advisers, or not having sufficient insight into market terms.<sup>1612</sup> Many investors may continue to invest with an adviser whose funds are unaudited because of their difficulties in identifying a new adviser who meets the investor's complex internal administrative and

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<sup>1610</sup> Utke and Mason Comment Letter.

<sup>1611</sup> *Id.*; Jennifer J. Gaver, Paul Mason & Steven Utke, *Financial Reporting Choices of Private Funds and Their Implications for Capital Formation* (May 4, 2020), available at <https://ssrn.com/abstract=3092331>.

<sup>1612</sup> *See supra* section VI.B.

regulatory requirements.<sup>1613</sup> The studies cited lastly do not include hedge funds, real estate funds, liquidity funds, or any other category of private fund whose adviser will be subject to the rule.<sup>1614</sup>

As discussed above, another commenter cites an academic study as stating that investors can “see through” any potential valuation manipulation that would be uncovered by an audit.<sup>1615</sup> We do not believe this literature undermines the potential benefits of a mandatory audit. First, also as discussed above, the paper cited itself concedes that in its findings, unskilled investors may misallocate capital, and that it is only the more sophisticated investors who may prefer the status quo to a regime with more regulation.<sup>1616</sup> We believe the commenter’s interpretation of this paper also ignores the costs that investors must currently undertake to “see through” manipulation, even on average.

Other commenters who questioned the benefits of a mandatory audit rule agreed that audits provide benefits but characterized the rule as unnecessary given current market practices around audits. For example, one commenter stated that the majority of funds today currently undergo an audit that meet the requirements of the final rule, consistent with the analysis above,<sup>1617</sup> and stated that this reflects the fact that current rules and market dynamics “work” and that “there is no market problem to be solved by the proposed rule.”<sup>1618</sup> Other commenters described the rule as duplicative.<sup>1619</sup> We disagree with commenters that there is no market

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<sup>1613</sup> *Id.*

<sup>1614</sup> Utke and Mason Comment Letter.

<sup>1615</sup> *See supra* section VI.C.3; *see also* AIC Comment Letter I, Appendix 1; Brown et al., *supra* footnote 1226.

<sup>1616</sup> *Id.*

<sup>1617</sup> *See supra* section VI.C.4.

<sup>1618</sup> PIFF Comment Letter.

<sup>1619</sup> BVCA Comment Letter; Invest Europe Comment Letter.



problem to be solved by the rule. We again point to the market failures as characterized above.<sup>1620</sup> In particular, as discussed above, we believe that certain targeted further reforms, such as mandatory audits, are necessitated by several additional sources of asymmetric bargaining power, because we believe those imbalances are not fully resolved by enhanced disclosure and would not be resolved by consent requirements.<sup>1621</sup>

As discussed above, some commenters criticized the proposed rule for eliminating the surprise examination option under the custody rule without evidence that surprise examinations have not adequately protected private fund investors.<sup>1622</sup> However, we believe that, because surprise examinations only verify the existence of pooled investment vehicle investments, a surprise examination may not discover any misappropriation or misvaluation until the assets are gone. Surprise examinations more generally do not provide other benefits that the final mandatory audit rule will provide such as checks on valuation, completeness and accuracy of financial statements, disclosures such as those regarding related-party transactions, and others.<sup>1623</sup> If, in lieu of an audit, a private fund undergoes a surprise examination, an investor may not receive this additional important information.

The benefits from mandatory audits are particularly relevant for illiquid investments. Illiquid assets currently are where we believe it is most feasible for financial information to have material misstatements of investment values and where there is broadly a higher risk of investor harm from potential conflicts of interest or fraud. This is because currently, as discussed above, advisers may use a high level of discretion and subjectivity in valuing a private fund's illiquid

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<sup>1620</sup> See *supra* section VI.B.

<sup>1621</sup> *Id.*

<sup>1622</sup> *Id.* See also, e.g., AIMA/ACC Comment Letter.

<sup>1623</sup> See *supra* sections II.C, VI.D.5.

investments, and the adviser further may have incentives to bias the fair value estimates of the investment upwards to generate larger fees.<sup>1624</sup> Because both liquid funds and illiquid funds may have illiquid investments, investors in both types of funds will benefit, though the benefits may be larger for investors in illiquid funds (as such funds may have more illiquid investments than liquid funds).

### *Costs*

As discussed above, we recognize that many advisers already provide audited financial statements to fund investors in connection with the adviser's alternative compliance with the custody rule.<sup>1625</sup> To the extent that an adviser does not currently have its private fund client undergo the required financial statement audit, there will be direct costs of obtaining the auditor, providing the auditor with resources needed to conduct the audit, the audit fees, and distributing the audit results to current investors.<sup>1626</sup> Under current practice, the costs of undergoing a financial statement audit are often paid by the fund, and therefore, ultimately, by the fund investors, though in some cases the costs may be partially or fully paid by the adviser. We expect similar arrangements may be made going forward to comply with the final rule, with disclosure where required: in some instances, the fund will bear the audit expense, in others the adviser will bear it, and there also may be arrangements in which both the adviser and fund will share the expense. Advisers could alternatively attempt to introduce substitute charges (for

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<sup>1624</sup> See *supra* section II.C.

<sup>1625</sup> See *supra* section VI.C.4.

<sup>1626</sup> The final audit rule's requirement to distribute audited financial statements within 120 days of the private fund's fiscal year-end and promptly upon liquidation may change the relevant compliance costs relative to the proposal, which required prompt distribution in all cases. The 120-day requirement may impose lower compliance costs relative to the proposal by providing more time for audits relative to the proposal, but a specific deadline requirement may also impose higher compliance costs relative to the flexible deadline approach of the proposal. The custody rule's requirement to distribute audited financial statements promptly upon liquidation generally aligns with the private fund audit requirements. See *supra* section II.C.

example, increased management fees) to cover the costs of compliance with the rule, but their ability to do so may depend on the willingness of investors to incur those substitute charges.

As discussed below, based on IARD data, as of December 31, 2022, there were 5,248 registered advisers providing advice to private funds, excluding advisers managing solely SAFs, and we estimate that these advisers would, on average, each provide advice to 10 private funds, excluding SAFs.<sup>1627</sup> We further estimate that the audit fee for the required private fund audit will be \$75,000 per fund on average, an estimate that has been revised upward from the Proposing Release in response to commenters.<sup>1628</sup> For purposes of the PRA, the estimated total auditing fees for all advisers to private funds will therefore be approximately \$3,936,000,000 annually.<sup>1629</sup> We further anticipate that the audit requirement will impose on all advisers to private funds a cost of approximately \$12,214,720 for internal time,<sup>1630</sup> yielding total costs of \$3,948,214,720. Because the final mandatory audit rule will not require advisers to obtain audits of CLOs or other SAFs, no costs will be borne by advisers or investors in the case of their CLOs or other SAFs.<sup>1631</sup>

However, some advisers to funds would obtain the required financial statement audits even in the absence of the final rule. The cost of the final audit requirement will therefore depend on the extent to which advisers currently obtain audits and, if so, whether the auditors are

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<sup>1627</sup> See *infra* section VII.C. IARD data indicate that registered investment advisers to private funds typically advise more private funds as compared to the full universe of investment advisers.

<sup>1628</sup> *Id.* The audit fee for an individual fund may be higher or lower than this estimate, with individual fund audit fees varying according to fund characteristics, such as the jurisdiction of the assets, complexity of the holdings, the firm providing the services, and economies of scales.

<sup>1629</sup> *Id.*

<sup>1630</sup> *Id.* As discussed above, one commenter criticized the quantification methods underlying these estimates, and we have explained why we do not agree with that criticism. See *supra* footnote 1366. Nevertheless, to reflect the commenter's concerns, and recognizing certain changes from the proposal, we are revising the estimates upwards as reflected here and in section VII.B.

<sup>1631</sup> See *supra* section II.A.

registered with the PCAOB and independent. We therefore believe that the costs incurred will approximate 12% of these amounts, because across all types of advisers to private funds besides securitized asset funds, approximately 88% of funds are currently audited in connection with the fund adviser's alternative compliance under the custody rule.<sup>1632</sup> This yields actual economic costs of \$473,785,766.40.

Moreover, even estimated costs of \$474 million may be overstated, because we have not deducted costs of surprise exams from advisers who do not get an audit today. Those advisers who are currently getting surprise exams instead of an audit will forgo the cost of the surprise exam once they are required to get an audit. However, we do not have reliable data on the typical cost of a surprise exam, and so we cannot quantify these potential cost savings. We also understand surprise exams to be substantially less expensive than audits, and so we do not believe we arrive at cost estimates that are excessively high by not deducting costs of surprise exams.<sup>1633</sup>

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<sup>1632</sup> See *supra* section VI.C.4, Figure 4A. These costs may be overstated because some advisers are only required to take all reasonable steps to cause the fund to undergo an audit, instead of being required to obtain an audit. See *supra* sections II.C.7, VI.C.4.

<sup>1633</sup> In 2009, the Commission staff estimated fees associated with surprise exams and found that costs of surprise exams vary substantially across advisers, ranging as high as \$125,000 annually, but that most advisers would face costs for surprise exams of between \$10,000 and \$20,000. See Custody Rule 2009 Adopting Release. However, we do not have reliable data on how those costs may have changed over time, including whether these costs have increased since 2009, or possibly decreased in the event that surprise examinations have gotten more efficient. We also do not have reliable data on how costs for surprise examinations for advisers of private funds may differ from the costs of surprise examinations for other investment advisers. Separately, the Commission staff recently estimated costs associated with advisers who would be subject to newly proposed surprise examination requirements. That analysis relied on the high end of the range of surprise examination costs, assuming costs of \$162,000 annually. The Safeguarding Release also cited a 2013 Government Accountability Office (GAO) study, which examined 12 average-sized registered advisers, found that the cost of surprise examinations ranged from \$3,500 to \$31,000. The GAO noted that the costs of surprise examinations vary widely across advisers and are typically based on the amount of hours required to conduct the examinations, which is a function of a number of factors including the number of client accounts under custody. See Safeguarding Release, *supra* footnote 467. Given these wide ranges of potential surprise examination costs, to be reasonable, we have not deducted cost savings from forgone surprise examination costs from our estimates of the quantified costs associated with the final audit rule in this release.

For funds that had received an audit by an auditor that is not registered with the PCAOB, the costs of audits will also be offset by a reduction in costs from no longer obtaining their previous audit, although we anticipate that the cost of the required audit will likely be greater because a PCAOB-registered and -inspected auditor who is independent may cost more than an auditor that is not subject to the same requirements. We requested comment on data that may facilitate quantification of these offsets,<sup>1634</sup> but no commenter offered any such data.

We also understand that the PCAOB registration and inspection requirement may limit the pool of auditors that are eligible to perform these services which could, in turn, increase costs, as a result of the potential for these auditors to charge higher prices for their services. The increase in demand for these services, however, may be limited in light of the high percentage of funds already being audited by such auditors.<sup>1635</sup> Several commenters emphasized these costs, stating that the proposed rule would substantially increase audit prices, for example because there may be an insufficient number of suitable auditors available.<sup>1636</sup>

We are not convinced that there may be an insufficient number of suitable auditors available. As shown in Figures 4 and 5 above, Form ADV shows growth in the number of audits by PCAOB-registered and -inspected independent private fund auditors of approximately 2,000 in 2020, approximately 3,000 in 2021, and approximately 6,000 in 2022.<sup>1637</sup> In 2022, there were only approximately 8,000 private funds that did not already undergo an audit from a PCAOB-registered and -inspected independent auditor. Moreover, the limitation of the final rules to not

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<sup>1634</sup> Proposing Release, *supra* footnote 3, at 280-285.

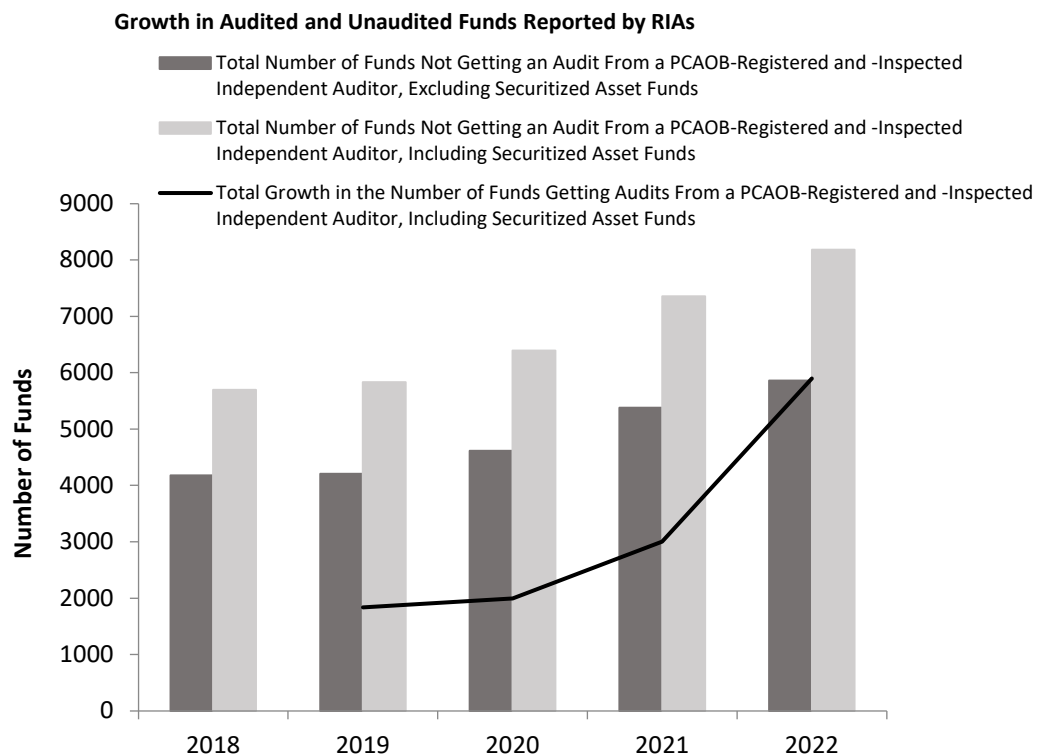
<sup>1635</sup> *Id.*

<sup>1636</sup> See, e.g., AIC Comment Letter I; AIMA/ACC Comment Letter; CFA Comment Letter I; SBAI Comment Letter, LaSalle Comment Letter.

<sup>1637</sup> See *supra* section VI.C.4.

apply to advisers with respect to SAFs further alleviates commenters’ concerns.<sup>1638</sup> Given that the rules will not apply to advisers with respect to SAFs, the final mandatory audit rule will only add approximately 5800 mandatory audits. These estimates are presented for comparison purposes in Figure 7.

Figure 7:



Source: Form ADV Schedule D, Section 7.B.(1) data filed between Oct. 1, 2021, and Sept. 30, 2022.

In other words, the audit industry has already organically, of its own accord, added a number of audits to its workload in the past year commensurate with the workload that will be added by the final rule. Moreover, the number of audits that will be added by the final rule is of the same order of magnitude as the number of audits added organically by the industry in each of

<sup>1638</sup> See *supra* section II.A.

the last several years. We believe this indicates that the audit industry is equipped to expand to meet the demand for additional audits without substantial additional costs, and so we do not believe that supply constraints on auditors because of the final rule will substantially increase the costs of private fund audits. This pattern and conclusion holds by type of private fund and by fund size.<sup>1639</sup> However, approximately 1,500 of these newly mandatory audits would be on funds of size \$2 million and under. To the extent that limited supply of auditors does increase the cost of the rule, for example by resulting in increased prices of audits, these costs may be particularly borne by advisers and investors to these smaller funds.

Several commenters further specify that the concern over a lack of a sufficient number of suitable auditors will particularly apply to funds that rely on Big Four auditing firms for various non-audit services. Several commenters state that certain funds get an audit from a Big Four firm because of their investors' demands, but none of the Big Four firms meet the independence requirements associated with the current custody rule for the fund.<sup>1640</sup> As discussed above, less than one percent of all funds get an additional surprise exam in addition to an audit, which indicates that no more than one percent of funds are managed by advisers who may face difficulty in getting an audit by an independent firm.<sup>1641</sup> Figure 6 above also further shows that only a *de minimis* number of funds, namely 149 out of almost 50 thousand, excluding securitized asset funds, are managed by advisers who may face difficulty in securing a PCAOB-registered and -inspected auditor.<sup>1642</sup>

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<sup>1639</sup> *Id.*

<sup>1640</sup> *Id.* See also, e.g., LaSalle Comment Letter; PWC Comment Letter.

<sup>1641</sup> *Id.*

<sup>1642</sup> *Id.* Based on staff review of Form ADV data, these funds range across all fund sizes and are not disproportionately larger or disproportionately smaller funds.

Because the case of funds that the adviser does not control and are neither controlled by nor under common control with the adviser (*e.g.*, where an unaffiliated sub-adviser provides services to the fund) only requires the adviser to take all reasonable steps to cause the fund undergo an audit that meets these elements,<sup>1643</sup> many investors in such funds will not bear any of the costs of the final rule.<sup>1644</sup> Similarly, because the final mandatory audit rule will not require advisers to obtain audits of CLOs and other SAFs, advisers to those funds will not face any costs under the rules with respect to those funds.<sup>1645</sup> Lastly, as noted above, we do not apply substantive provisions of the Advisers Act and its rules, including the mandatory audit requirement, with respect to non-U.S. clients (including private funds) of an SEC registered offshore investment adviser.<sup>1646</sup> We believe that this clarification will reduce many of the concerns expressed by commenters regarding the difficulty for non-U.S. private fund advisers finding an auditor in certain jurisdictions.

The proposed Commission notification requirement is not present in the final rule, and thus does not represent a new cost.<sup>1647</sup> While one commenter questioned the benefits of this notification requirement, commenters did not address the costs of this notification requirement in their comments.<sup>1648</sup>

Because the final rule aligns the private fund mandatory audit requirement with the custody rule audit requirement, advisers under the final rule will also face lower costs than under the proposal by avoiding any confusion associated with differences in the requirements of the

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<sup>1643</sup> See *supra* section II.C.

<sup>1644</sup> See *supra* sections II.C, VI.C.4.

<sup>1645</sup> See *supra* section II.C.

<sup>1646</sup> See, *e.g.*, Exemptions Adopting Release, *supra* footnote 9.

<sup>1647</sup> See *supra* VI.C.4.

<sup>1648</sup> NYC Bar Comment Letter II.



two rules. Several commenters stated that differences between the two rules could create a risk of confusion.<sup>1649</sup>

The indirect costs of the audit requirement will depend on the quality of the financial statements of the funds newly subject to audits. These costs may be relatively higher for the funds with lower quality financial statements (*i.e.*, the funds with the greatest benefit from the audit requirement). The indirect costs from the independent audit requirement may include costs of changing the fund's internal financial reporting practices, such as improvements to internal controls over financial reporting, to avoid potential harm to investors from a misstatement. Further, because the requirement to have the auditor registered with, and subject to the regular inspection by, the PCAOB may limit the pool of accountants that are eligible to perform these services,<sup>1650</sup> the resulting competition for these services might generally lead to an increase in their costs, as an effect of the final rule. Commenters did not address these types of indirect costs in their comments.

## **6. Adviser-Led Secondaries**

In addition, the final adviser-led secondaries rule will require advisers to obtain fairness opinions or valuation opinions from an independent opinion provider in connection with certain adviser-led secondary transactions with respect to a private fund. In connection with this opinion, the final rule also requires a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider. The final adviser-led secondaries rule differs from the proposal in that it allows a fund to obtain either a fairness opinion or a valuation opinion in connection with certain

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<sup>1649</sup> See, *e.g.*, IAA Comment Letter II; NYC Bar Comment Letter II; AIC Comment Letter I.

<sup>1650</sup> See *supra* footnote 1640 and accompanying text.

adviser-led secondary transactions instead of requiring a fairness opinion and specifies a timeline for the delivery of this opinion to investors.<sup>1651</sup>

This requirement will not apply to advisers that are not required to register as investment advisers with the Commission, such as State-registered advisers and exempt reporting advisers. This requirement will also not apply where the transaction is a tender offer instead of an adviser-led secondary transaction as defined in the rule, and so neither the benefits nor the costs will apply in the case of tender offers.<sup>1652</sup> This will be the case if an investor is not faced with the decision between (1) selling all or a portion of its interest and (2) converting or exchanging all or a portion of its interest.<sup>1653</sup> Generally, if an investor is allowed to retain its interest in the same fund with respect to the asset subject to the transaction on the same terms (*i.e.*, the investor is not required to either sell or convert/exchange), as many tender offers permit investors to do, then the transaction will not qualify as an adviser-led secondary transaction. We discuss the costs and benefits of this rule provisions below. Several factors, however, make the quantification of many of the economic effects of the final amendments and rules difficult. For example, there is a lack of quantitative data on the extent to which adviser-led secondaries with neither fairness opinions nor valuation opinions differ in fairness of price from adviser-led secondaries with either fairness opinions or valuation opinions attached. It would also be difficult to quantify how investors and advisers may change their preferences over secondary transactions once fairness opinions are required to be provided. As a result, parts of the discussion below are qualitative in nature.

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<sup>1651</sup> See *supra* section II.C.8.

<sup>1652</sup> *Id.*

<sup>1653</sup> *Id.*

## *Benefits*

The final rule's requirement that an adviser distribute a fairness opinion or valuation opinion and summary of material business relationships with the opinion provider in connection with certain adviser-led secondary transactions may provide benefits to investors in the specific context of adviser-led secondary transactions similar to the effects of the mandatory audit rule.<sup>1654</sup> This requirement will provide an important check against an adviser's conflicts of interest in structuring and leading these transactions. Investors will have decreased risk of experiencing harm from mis-valuation of secondary-led transactions. Further, anticipating a lower risk of harm from mis-valuation when participating in such transactions, investors may be more likely to participate. The result may be a closer alignment between investor choices and investor preferences over private fund terms, investment strategies, and investment outcomes. These benefits will, however, be reduced to the extent that advisers are already obtaining fairness opinions or valuation opinions as a matter of best practice.

While the final rule, in a change from the proposal, will also allow for the use of a valuation opinion instead of a fairness opinion, we understand that a valuation opinion will still provide investors with a strong basis to make an informed decision.<sup>1655</sup> A valuation opinion is a written opinion stating the value (either as a single amount or a range) of any assets being sold as part of an adviser-led secondary transaction.<sup>1656</sup> By contrast, a fairness opinion addresses the fairness from a financial point of view to a party paying or receiving consideration in a transaction.<sup>1657</sup> One commenter stated that the financial analyses used to support a fairness

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<sup>1654</sup> See *supra* section VI.D.5.

<sup>1655</sup> See *supra* sections II.D.2, VI.C.4; see also Houlihan Comment Letter.

<sup>1656</sup> Houlihan Comment Letter.

<sup>1657</sup> See *supra* sections II.D.2, VI.C.4

opinion and valuation opinion are substantially similar.<sup>1658</sup> Both types of opinions generally yield implied or indicative valuation ranges.<sup>1659</sup>

Because the final rule differs from the proposal in that tender offers will not be captured by the definition in the rule when the investor is not faced with the decision between (1) selling all or a portion of its interest and (2) converting or exchanging all or a portion of its interest, advisers may have additional incentives to structure transactions as tender offers instead of as adviser-led secondary transactions.<sup>1660</sup> That is, advisers may have additional incentives to offer investors more choices than just a choice between selling all or a portion of their interests and converting or exchanging all or a portion of their interests. To the extent this occurs, investors may benefit from having greater flexibility in such transactions to, for example, continue to receive exposure to the assets that are at issue in the transaction by retaining its interest in the same fund on the same terms.<sup>1661</sup>

Because the final rule specifies that the adviser-led secondaries rule will not apply to advisers in the case of SAFs,<sup>1662</sup> there will be no accrual of benefits to investors associated with transactions such as CLO re-issuances.<sup>1663</sup> However, we believe these forgone benefits are negligible, in particular because SAF re-issuances typically specify that outstanding debt tranches are fully repaid at par. The investor benefits from the adviser-led secondaries rule primarily accrue from the check provided to investors against an adviser's potential conflict of interest that could provide an incentive for an adviser to mis-value assets when the answer is on

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<sup>1658</sup> See *supra* sections II.D.2, VI.C.4

<sup>1659</sup> *Id.*

<sup>1660</sup> See *supra* section II.D.1.

<sup>1661</sup> *Id.*

<sup>1662</sup> See *supra* section II.A.

<sup>1663</sup> See *supra* section II.C.8.

both sides of a transaction. Because investors are fully paid at par, there is no risk of harm from the adviser mis-valuing the assets.<sup>1664</sup>

Some commenters agreed with the stated benefits of the final rule as outlined in the Proposing Release, and generally supported it.<sup>1665</sup> Other commenters were skeptical of the stated benefits of acquiring a fairness opinion for all adviser-led secondary transactions as would have been required by the proposal.<sup>1666</sup> While acknowledging that fairness opinions can be a useful tool in mitigating information asymmetries between the adviser and their investors, these commenters stated that funds often will not seek such an opinion because it would provide little benefit to investors and would come at a high cost.<sup>1667</sup> The commenters argued further that in cases where funds did not obtain a fairness opinion, other practices were in place to guarantee investor protection consistent with the adviser's fiduciary duty, such as a competitive bidding process or recent arms-length transaction.<sup>1668</sup> We recognize that there will be transactions for which a fairness opinion or valuation opinion will provide less benefit to investors because of the existence of these other mechanisms for independent price valuation that may already be in place.

However, we continue to believe that this requirement will, in many cases, provide the above benefits to investors. Moreover, it is the staff's understanding that adviser-led secondaries

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<sup>1664</sup> *Id.* Equity investors in SAFs may face risks of harm from mis-valuations and may therefore have forgone benefits from not applying the rules to advisers with respect to SAFs. However, equity investors in SAFs are typically only a small portion of the fund, include the adviser and its related persons themselves as well as advisers to other large private funds, and do not typically include pension funds. *See supra* sections VI.C.1, VI.C.2. These factors mitigate the risks of any harm to the equity tranche, and so mitigate the forgone benefits from not applying the rules to advisers with respect to those funds.

<sup>1665</sup> *See, e.g.,* ILPA Comment Letter I; CFA Comment Letter I; Morningstar Comment Letter.

<sup>1666</sup> *See, e.g.,* PIFF Comment Letter; AIC Comment Letter II; Ropes & Gray Comment Letter.

<sup>1667</sup> *Id.*

<sup>1668</sup> *Id.*

also occur during times of stress, and may be associated with an adviser who needs to restructure a portfolio investment.<sup>1669</sup> In other instances, an adviser may use an adviser-led secondary transaction to extend an investment beyond the contractually agreed upon term of the fund that holds it.<sup>1670</sup> These may be particularly risky cases for investors as the risk of a conflict of interest may be high, and so fairness opinions or valuation opinions may provide particularly high benefits in those cases. Lastly, we also believe that ensuring that such opinions are delivered to investors in a time frame that would allow them to use that information in their decision-making process will increase the benefit of this rule to investors.

Similar to the final mandatory audit rule, the benefits from mandatory fairness opinions/valuation opinions are particularly relevant for illiquid investments. Illiquid assets currently are where we believe it is most feasible for adviser-led secondary transactions to occur at unfair prices, and where there is broadly a higher risk of investor harm from potential conflicts of interest or fraud and where there is the greatest risk of asymmetry of information between investors and the adviser. This is because currently, as discussed above, advisers may use a high level of discretion and subjectivity in valuing a private fund's illiquid investments, and the adviser further may have incentives to bias the fair value estimates of the investment to generate a more favorable price in the secondary transaction.<sup>1671</sup> Because both liquid funds and illiquid funds may have illiquid investments, investors in both types of funds will benefit, though the benefits may be larger for investors in illiquid funds (as such funds may have more illiquid investments than liquid funds and are more likely to have adviser-led secondary transactions).

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<sup>1669</sup> See *supra* section VI.C.4.

<sup>1670</sup> *Id.*

<sup>1671</sup> See *supra* section II.C.8.

Because Form PF’s recently adopted new quarterly reporting requirements for private equity fund advisers will already collect quarterly information on the occurrence of adviser-led secondaries (after the effective date of the Form PF final amendments, albeit with a definition of “adviser-led secondary” that is not identical to the definition used for the adviser-led secondaries rule), any investor protection benefits of the final rules may be mitigated to the extent that Form PF is already a sufficient tool for investor protection purposes.<sup>1672</sup> However we do not believe the benefits will be substantially mitigated, because Form PF is not an investor-facing disclosure form. Information that private fund advisers report on Form PF is provided to regulators on a confidential basis and is nonpublic.<sup>1673</sup> The benefits from the final rules accrue substantially from fairness opinions and valuation opinions decreasing risks of investors experiencing harm from mis-valuation of secondary-led transactions. To the extent that advisers’ incentives to independently pursue fairness opinions and valuation opinions are increased by Form PF’s requirement (after the effective date of the new amendments) to report adviser-led secondaries to the Commission, that change in incentives from Form PF’s amendments will reduce both the benefits and costs of the final rules (since the final result is, regardless, the adviser being incentivized to pursue a fairness opinion or valuation opinion, no matter which rule was the predominating factor in the adviser’s decision).

#### *Costs*

Costs would also be incurred related to obtaining the required fairness opinion or valuation opinion and material business relationship summary in the case of an adviser-led secondary transaction. For purposes of the PRA, we estimate that 10% of advisers providing

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<sup>1672</sup> See *supra* section VI.C.4.

<sup>1673</sup> See *supra* section VI.C.3.

advice to private funds conduct an adviser-led secondary transaction each year and that the funds would pay external costs of \$100,565 for each fairness opinion or valuation opinion and material business relationship summary.<sup>1674</sup> Because only approximately 10% of advisers conduct an adviser-led secondary transaction each year, the estimated total fees for all funds per year would therefore be approximately \$52,796,625.<sup>1675</sup> Further, as discussed in section VII.E below, we anticipate that the fairness opinion or valuation opinion and material business relationship summary requirements would impose a cost of approximately \$2,800,507.50 for internal time annually.<sup>1676</sup> These costs will be borne primarily, though not exclusively, by closed-end illiquid funds,<sup>1677</sup> as these are the funds that most frequently have the adviser-led secondaries considered by the rule. Because the final adviser-led secondaries rule will not apply to advisers with respect to SAFs,<sup>1678</sup> there will be no accrual of costs to advisers associated with transactions such as CLO re-issuances.<sup>1679</sup>

To the extent that certain hedge fund or other open-end private fund transactions are captured by the rule, these funds and their investors would also face comparable fees and costs.

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<sup>1674</sup> See *infra* section VII.D.

<sup>1675</sup> *Id.* One commenter's calculation of aggregate costs associated with the adviser-led secondaries rule yields substantially higher aggregate costs, but per-fund costs comparable to those reflected here. The commenter's aggregate cost result is driven by the commenter assuming that the adviser-led secondaries rule's costs would be borne over 4,533 fairness opinions instead of 504, as was assumed by the Proposing Release. See LSTA Comment Letter, Exhibit C. This assumption would require that approximately 90% of registered advisers undertake an adviser-led secondary each year, as Form ADV data indicate there are currently approximately 5,000 registered advisers to private funds. See *supra* VI.C.1. We do not believe this is a reasonable assumption and have continued to assume approximately 10% of advisers conduct an adviser-led secondary transaction each year.

<sup>1676</sup> *Id.* As discussed above, one commenter criticized the quantification methods underlying these estimates, and we have explained why we do not agree with that criticism. See *supra* footnote 1366. Nevertheless, to reflect commenters' concerns, and recognizing certain changes from the proposal, we are revising the estimates upwards as reflected here and in section VII.B.

<sup>1677</sup> See *supra* section II.C.8.

<sup>1678</sup> See *supra* section II.A.

<sup>1679</sup> See *supra* section II.C.8.



The costs associated with obtaining fairness opinions or valuation opinions could dissuade some private fund advisers from leading these transactions, which could decrease liquidity opportunities for some private fund advisers and their investors. Under current practice, some investors bear the expense associated with obtaining a fairness opinion or valuation opinion if there is one. We expect similar arrangements may be made going forward to comply with the final rule, with disclosure where required. Advisers could alternatively attempt to introduce substitute charges (for example, increased management fees) to cover the costs of compliance with the rule, but their ability to do so may depend on the willingness of investors to incur those substitute charges. We do not believe that specifying a timeline for delivery of the opinion will significantly change the cost of compliance.

Conversely, to the extent that advisers restructure their transactions as tender offers to avoid being captured by the definition of adviser-led secondary, private fund advisers and their investors may be able to mitigate the costs of the final rule.<sup>1680</sup>

Some commenters highlighted the costs associated with obtaining a fairness opinion.<sup>1681</sup> These commenters also cited indirect consequences as a result of the high costs of fairness opinions. One commenter suggested that the time required to obtain and distribute a fairness opinion could create “unnecessary delay, which can put transaction completion at risk.”<sup>1682</sup> Another stated that for some transactions, a fairness opinion may not be available, which would effectively bar the transaction even if the benefits of the transaction to investors were large.<sup>1683</sup> Another noted that opinion providers may need to create or update a database of business

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<sup>1680</sup> See *supra* section II.D.1.

<sup>1681</sup> MFA Comment Letter I; MFA Comment Letter I, Appendix A; Ropes & Gray Comment Letter.

<sup>1682</sup> AIC Comment Letter I.

<sup>1683</sup> PIFF Comment Letter.

relationships, and that this cost may ultimately be borne at least partially by investors.<sup>1684</sup>

However, many of these commenters stated that a valuation opinion would be less costly in most circumstances.<sup>1685</sup> We believe that these commenters' concerns on costs are substantially mitigated by the option in the final rule for a valuation opinion instead of a fairness opinion, but at the margin these types of indirect consequences may still occur.

## **7. Written Documentation of All Advisers' Annual Review of Compliance Programs**

Amendments to rule 206(4)-7 under the Advisers Act will require all advisers, not just those to private funds, to document the annual review of their compliance policies and procedures in writing. These requirements will apply to advisers with respect to their SAFs, and so the benefits and costs below will apply even in the case of SAFs. We discuss the costs and benefits of this amendment below. Several factors, however, make the quantification of many of the economic effects of the final amendments and rules difficult. As a result, parts of the discussion below are qualitative in nature.

### *Benefits*

The rule amendment requiring all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing will allow our staff to better determine whether an adviser has complied with the review requirement of the compliance rule, and will facilitate remediation of non-compliance. Because our staff's determination of whether the adviser has complied with the compliance rule will become more effective, the rule amendment

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<sup>1684</sup> AIC Comment Letter I, Appendix 1.

<sup>1685</sup> MFA Comment Letter I; MFA Comment Letter I, Appendix A; AIC Comment Letter I.

may reduce the risk of non-compliance, as well as any risk to investors associated with non-compliance. Several commenters agreed with these benefits.<sup>1686</sup>

The commenters who disagreed with the rule amendment generally emphasized the costs of the change, instead of questioning the benefits, as discussed further below in this section. However, one commenter stated that the amendment would be unnecessarily burdensome and duplicative for asset managers that have multiple registered investment advisers operating under a common compliance program<sup>1687</sup> The commenter stated that, under the proposed amendment, RIAs in an advisory complex would be producing multiple duplicative reports with little variation, and where one or more of those advisers are advisers to RICs, the report would largely be overlapping with and duplicative of the 38a-1 compliance program written report.<sup>1688</sup> While the benefits of the produced reports may diminish with each marginal report produced with little variation, the costs will likely also decrease. We also do not believe that the marginal benefits of each report will be *de minimis*: For RIAs in an advisory complex with many advisers, producing each report may help advisers assess whether they have considered any compliance matters that arose during the previous year, changes in business activities, or changes to the Advisers Act or other rules and regulations that may impact that particular adviser. Even if, in certain cases, consideration of such issues produces a similar report to a previous one, there may be broader benefits across the industry from standardizing the practice of advisers making such assessments throughout their entire advisory complex. Another commenter compared the rule to Rule 38a-1 of the Investment Company Act, and stated such a written documentation requirement is only

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<sup>1686</sup> See, e.g., CFA Comment Letter I; IAA Comment Letter II; Convergence Comment Letter; NRS Comment Letter.

<sup>1687</sup> SIFMA-AMG Comment Letter I.

<sup>1688</sup> *Id.*

relevant for funds with retail investors. While we do not have the necessary data to determine whether the benefits of such requirements, or similar requirements, are higher for retail investors or other types of fund investors we continue to believe the above benefits will broadly accrue for investors to both types of funds.

The benefits from documentation of compliance programs will be relevant for all investors, as the rule applies to all advisers that are registered or required to register, not just private fund advisers. In addition, the lack of legacy status for this rule amendment mean that these benefits will accrue across all registered advisers.

### *Costs*

Lastly, the required documentation of the annual review of the adviser's compliance program has direct costs that include the cost of legal services associated with the preparation of such documentation. As discussed below, for purposes of the PRA, we anticipate that the requirement for all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing would, for all advisers, impose cost of approximately \$40,890,982 for internal time, and approximately \$3,525,579 for external costs.<sup>1689</sup> One commenter agreed that the rule would entail direct costs.<sup>1690</sup> Other commenters stated there would be indirect costs of the rule, such as chilled communications between an adviser and compliance consultants or outside counsel and less tailored compliance reviews.<sup>1691</sup> The lack of

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<sup>1689</sup> See *infra* section VII.G.

<sup>1690</sup> NYC Bar Comment Letter II.

<sup>1691</sup> Curtis Comment Letter; SBAI Comment Letter.

<sup>1691</sup> In connection with the written report required under rule 38a-1, the Compliance Rule Adopting Release stated that “[a]ll reports required by our rules are meant to be made available to the Commission and the Commission staff and, thus, they are not subject to the attorney-client privilege, the work-product doctrine, or other similar protections.” See *supra* footnote 905.

legacy status for this rule amendment mean that these costs will be borne across all SEC-registered advisers.<sup>1692</sup>

## **8. Recordkeeping**

Finally, the amendment to the Advisers Act recordkeeping rule will require advisers who are registered or required to be registered to retain books and records related to the quarterly statement rule,<sup>1693</sup> to retain books and records related to the mandatory adviser audit rule,<sup>1694</sup> to support their compliance with the adviser-led secondaries rule,<sup>1695</sup> to support their compliance with the preferential treatment disclosure rule,<sup>1696</sup> and to support their compliance with the restricted activities rule.<sup>1697</sup> The benefit to investors will be to enable an examiner to verify more easily that a fund is in compliance with these rules and to facilitate the more timely detection and remediation of non-compliance. These requirements will also help facilitate the Commission's enforcement and examination capabilities. Also beneficial to investors, advisers may react to the enhanced ability of third parties to detect and impose sanctions against non-compliance due to the recordkeeping requirements by taking more care to comply with the substance of the rule. The lack of legacy status for this rule provision means that these benefits will accrue across all private funds and advisers.

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<sup>1692</sup> There do not exist reliable data for quantifying what percentage of private fund advisers today engage in this activity or the other restricted activities. For the purposes of quantifying costs, including aggregate costs, we have applied the estimated costs per adviser to all advisers in the scope of the rule, as detailed in section VII.

<sup>1693</sup> *See supra* section II.B.5.

<sup>1694</sup> *See supra* section II.C.8.

<sup>1695</sup> *See supra* section II.D.5.

<sup>1696</sup> *See supra* section II.G.6.

<sup>1697</sup> *See supra* section II.E.

These requirements will impose costs on advisers related to maintaining these records. Several commenters stated that the recordkeeping requirements would be burdensome.<sup>1698</sup> In addition to the compliance burden, commenters stated that the recordkeeping requirements posed a risk of having proprietary data exposed to hackers,<sup>1699</sup> or that requiring the adviser to retain records regarding prospective investors that do not ultimately invest in the fund may conflict with other legal obligations applicable to the adviser, resulting in additional legal costs.<sup>1700</sup> With respect to the written documentation of the adviser's annual reviews of its compliance programs, commenters stated that the requirement to disclose the review of the compliance program may have a chilling effect on outside compliance consultants' willingness to prepare compliance reviews for private fund advisers,<sup>1701</sup> or may cause compliance reviews to be less tailored to the adviser's specific risks.<sup>1702</sup>

While the final rules may result in some of these effects, we do not have a basis for quantifying the cost of these effects, and no basis was provided by the commenters. As discussed below, for purposes of the PRA, we anticipate that the additional recordkeeping obligations would impose, for all advisers, an annual cost of approximately \$22,430,631.25.<sup>1703</sup> The lack of legacy status for this rule provision means that these costs will be borne across all

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<sup>1698</sup> See, e.g., AIMA/ACC Comment Letter; ATR Comment Letter.

<sup>1699</sup> ATR Comment Letter.

<sup>1700</sup> AIMA/ACC Comment Letter.

<sup>1701</sup> Curtis Comment Letter.

<sup>1702</sup> SBAI Comment Letter.

<sup>1703</sup> We have adjusted these estimates to reflect that the final quarterly statement, audit, adviser-led secondaries, restricted activities, and preferential treatment rules will not apply to SAF advisers with respect to SAFs they advise as well. See *infra* section VII.H. As discussed above, one commenter criticized the quantification methods underlying these estimates, and we have explained why we do not agree with that criticism. See *supra* footnote 1366. Nevertheless, to reflect the commenter's concerns, and recognizing certain changes from the proposal, we are revising the estimates upwards as reflected here and in section VII.B.

private funds and advisers. Because the final rules with new recordkeeping components will not apply to advisers with respect to CLOs and other SAFs, they will not face any new recordkeeping requirements in the case of their CLOs and SAFs, and so there will be no benefits or costs for investors and advisers associated with those funds from the final recordkeeping rules.<sup>1704</sup>

## **E. Effects on Efficiency, Competition, and Capital Formation**

### **1. Efficiency**

The final rules will likely enhance economic efficiency by enabling investors more easily to identify funds that align with their preferences over private fund terms, investment strategies, and investment outcomes, and also by causing fund advisers to align their actions more closely with the interests of investors through the elimination of prohibited practices.

First, the final rules may increase the usefulness of the information that investors receive from private fund advisers regarding the fees, expenses, and performance of the fund, and regarding the preferential treatment of certain investors of the fund through the more detailed and standardized disclosures as well as consent requirements discussed above.<sup>1705</sup> These enhanced disclosures and consent requirements will provide more information to investors regarding the ability and potential fit of investment advisers, which may improve the quality of the matches that investors make with private funds and investment advisers in terms of fit with investor preferences over private fund terms, investment strategies, and investment outcomes. The enhanced disclosures may also reduce search costs, as investors may be better able to evaluate

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<sup>1704</sup> See *supra* section II.A.

<sup>1705</sup> See *supra* sections VI.D.1, VI.D.3. See also, e.g., Consumer Federation of America Comment Letter.

the funds of an investment adviser based on the information to be disclosed at the time of the investment and in the quarterly statement.

Regarding preferential treatment, the final rules further align fund adviser actions and investor interests by prohibiting certain preferential treatment practices altogether (instead of only requiring disclosure or consent), specifically prohibiting preferential terms regarding liquidity or transparency that have a material, negative impact on investors in the fund or a similar pool of assets.<sup>1706</sup> Prohibiting these activities, and prohibiting remaining preferential treatment activities unless certain disclosures are provided, may eliminate some of the complexity and uncertainty that investors face about the outcomes of their investment choices, further reducing costs investors must undertake to find appropriate matches between their choice of private fund and their preferences over private fund terms, investment strategies, and investment outcomes.

While many of the final disclosure and consent requirements involve making disclosures to and, in some cases, obtaining consent from only current investors, and not prospective investors, the rule's requirements may enhance efficiency through the tendency of some fund advisers to rely on investors in current funds to be prospective investors in their future funds. For example, when fund advisers raise multiple funds sequentially, current investors can base their decisions on whether to invest in subsequent funds based on the disclosures of the prior funds.<sup>1707</sup> As such, improved disclosures and consent requirements can improve the efficiency of investments without directly requiring disclosures to all prospective investors. Investors may

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<sup>1706</sup> See *supra* section II.F.

<sup>1707</sup> See *supra* section VI.C.3.



therefore face a lower overall cost of searching for, and choosing among, alternative private fund investments.

Lastly, the rules prohibit certain activities that represent possible conflicting arrangements between investors and fund advisers, with certain exceptions where certain disclosures regarding those activities are made and, in some cases, where the required investor consent is also obtained. To the extent that investors currently bear costs of searching for fund advisers who do not engage in these arrangements, or bear costs associated with monitoring fund adviser conduct to avoid harm, then prohibiting these activities may lower investors' overall costs of searching for, monitoring, and choosing among alternative private fund investments. This may particularly be the case for smaller investors who are currently more frequently harmed by the activities being considered. The same effect may occur in the case of the final rules' requirements for advisers to obtain audits of fund financial statements. To the extent that investors currently bear costs of searching for fund advisers who do have their funds undergo audits, or bear costs associated with monitoring fund adviser conduct to avoid harm when the adviser does not have the fund undergo an audit, the final mandatory audit rule will enhance investor protection and thereby improve the efficiency of the investment adviser search process.

The above pro-efficiency effects may also be strengthened by the reduced risks of non-compliance and increased efficiency of the Commission's enforcement and examination of non-compliance resulting from the final amendments to the compliance rule for a written documentation requirement and the amendments to the books and records rule.<sup>1708</sup>

There may be losses of efficiency from the rules prohibiting various activities, and from any changes in fund practices in response to the rules, to the extent that investors currently

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<sup>1708</sup> See *supra* sections VI.D.7, VI.D.8.

benefit from those activities or incur costs from those changes. For example, investors who currently receive preferential terms that will be prohibited under the final rules may have only invested with their current adviser because they were able to secure preferential terms. With those preferential terms removed, those investors may choose to reevaluate the match between their choice of adviser and their overall preferences over private fund terms, investment strategy, and investment outcomes. Depending on the results of this reevaluation, those investors may choose to incur costs of searching for new fund advisers or alternative investments.

Other risks to efficiency may arise from the scope of the final rules, for example the private fund adviser rules not applying to advisers with respect to their CLOs and other SAFs. Because advisers to SAFs will face no costs under the private fund adviser rules with respect to their SAFs, more advisers may choose to structure their funds as an SAF so as to avoid the costs of the rules. To the extent this choice by advisers only occurs because advisers are incentivized to reduce their compliance costs, but those advisers would have greater skill or comparative advantage in advising other types of private funds, the effect the final rules have on adviser choice of fund structure may reduce efficiency.<sup>1709</sup> Similarly, advisers restructuring their funds to meet the definition of SAF may be viewed as a potentially costly form of regulatory arbitrage. We believe these effects will be mitigated by (1) the definition of SAFs that includes the fund primarily issuing debt, which is a structure we believe advisers who normally issue equity will not want to use just to lower their compliance costs and avoid the restrictions and prohibitions in the private fund adviser rules, and (2) the fact that any advisers considering restructuring their

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<sup>1709</sup> A policy in which advisers are incentivized only to pursue fund structures that align with their individual desires (e.g., their comparative advantage, or the needs of their investors), is described in economics as “incentive compatible.” The risk to efficiency from distorting adviser incentives may be viewed as a risk of reducing the incentive compatibility of the final rules. *See, e.g.,* ANDREU MAS-COLELL, ET. AL., Chapter 13, MICROECONOMIC THEORY (Oxford Univ. Press, 1995), for a discussion of incentive compatibility.

funds to be SAFs will need to be confident that they are able to compete existing SAFs to attract SAF investors. However, at the margin, these risks of reduced efficiency may occur.

The limited scope regarding SAF advisers may also result in a rule with lower efficiency gains relative to a rule with no such limitation. This is because the efficiency gains from the rule accrue, in part, from the enhanced comparability and transparency across private funds, and comparability effects are strongest when a rule is applied across all types of funds. The limitation may make SAFs less comparable to other types of funds, which may yield lower efficiency benefits when investors search across fund types for an adviser. However, we believe that the distinct features that we understand CLOs and other SAFs already have today likely result in investors already viewing CLOs and other SAFs as distinct types of investments and not comparable to an equity interest in other funds.<sup>1710</sup> To the extent that few, or no, investors would compare SAFs and other types of private funds on the basis of the required reporting elements of the private fund adviser rules, then the loss of any efficiency benefits from reduced comparability is minimal. Moreover, many advisers to SAFs, in particular advisers to CLOs, typically provide extensive reporting and transparency already, such as regular reporting of every asset in the fund's portfolio and their current market valuation. This furthers the likelihood that the loss of efficiency gains from forgoing the final rules' transparency benefits with respect to advisers to SAFs will be minimal.<sup>1711</sup>

There may also be a risk of the transparency benefits of the rule getting reduced by advisers restructuring their funds to be SAFs to meet the exclusion under the final rules. Any adviser restructuring their fund into a SAF to reduce their compliance costs or avoid the

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<sup>1710</sup> See *supra* sections II.A, VI.C.2, VI.C.3.

<sup>1711</sup> See *supra* section VI.C.3.

restrictions and prohibitions in the private fund adviser rules would result in a fund less comparable to other types of private funds. However, these risks are also likely to be mitigated by the fact that any such adviser would need to compete with the existing CLO and broader SAF landscape. In particular, any such adviser seeking to attract investors to a new SAF would likely need to arrange for or issue independent collateral administrator reports that, like existing CLOs and other SAFs, detail all cash flows associated with the assets in their fund portfolio and list all market values of the assets in their fund portfolio.<sup>1712</sup> An adviser who restructures a fund into a SAF but meets the same typical transparency practices as existing CLOs and other SAFs would not result in any substantial loss of transparency benefits associated with the final rule.

Many commenters emphasized the risks to potential losses of efficiency and questioned the possible benefits to efficiency.<sup>1713</sup> Some commenters emphasized particular provisions of the rule as bearing substantial risks to efficiency, such as the proposed prohibition on pass-through of certain fees and expenses.<sup>1714</sup> Other commenters raised broad concerns that the entire regime would reduce efficiency by restricting the ability of market participants to freely negotiate contractual terms among themselves.<sup>1715</sup> Other commenters stated broadly that the Proposing Release economic analysis had failed to consider important ways in which the proposed rules may affect efficiency.<sup>1716</sup> We believe many of commenters' concerns are mitigated by the revisions to the final rules as compared to the proposed rules, such as the provision of certain exceptions for many of the proposed activities where certain disclosures are

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<sup>1712</sup> See *supra* section VI.C.3.

<sup>1713</sup> See, e.g., AIMA/ACC Comment Letter; AIC Comment Letter I, Appendix 1; AIC Comment Letter I, Appendix 2; PIFF Comment Letter.

<sup>1714</sup> See, e.g., AIC Comment Letter I, Appendix 1.

<sup>1715</sup> AIC Comment Letter I, Appendix 2.

<sup>1716</sup> See, e.g., AIC Comment Letter I, Appendix 2.

made and, in some cases, where the required investor consent is also obtained. However, at the margin there may still be risks of reduced efficiency.

## **2. Competition**

The final rules may also affect competition in the market for private fund investing.

First, to the extent that the enhanced transparency of certain fees, expenses, and performance of private funds under the final rules may reduce the cost to some investors of comparing private fund investments, then current investors evaluating whether to continue investing in subsequent funds with their current adviser may be more likely to reject future funds raised by their current adviser in favor of the terms of competing funds offered by competing advisers, including new funds that advisers may offer as alternatives that they would not have offered absent the increased transparency, or competing advisers whom the investor would not have considered absent the increased transparency, including newer or smaller advisers. For example, we understand that subscription facilities can distort fund performance rankings and distort future fundraising outcomes,<sup>1717</sup> and so the enhanced disclosures around the impact of subscription facilities on performance may change how investors compare prospective funds in the future. To the extent that this heightened transparency encourages advisers to make more substantial disclosures to prospective investors, investors may also be able to obtain more detailed fee and expense and performance data for other prospective fund investments, strengthening the effect of the rules on competition.<sup>1718</sup> Advisers may therefore update the terms that they offer to investors, or investors may shift their assets to different funds.

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<sup>1717</sup> See *supra* sections VI.C.3, VI.D.2; see also, e.g., Schillinger et al., *supra* footnote 1213; Enhancing Transparency Around Subscription Lines of Credit, *supra* footnote 1001.

<sup>1718</sup> See *supra* section VI.D.1.

Second, because enhanced transparency of preferential treatment will be provided to both current and prospective investors, there may be reduced search costs to all investors seeking to compare funds on the basis of which investors receive preferential treatment. For example, some advisers may lose investors from their future funds if those investors only participated in that adviser's prior funds because of the preferential terms they received. We anticipate that investors withdrawing from a fund because of a loss of preferential treatment would redeploy their capital elsewhere, and so new advisers would have a new pool of investment capital to pursue.

These pro-competitive effects of the rule will directly benefit private funds with advisers within the scope of the final rules and investors in those funds.<sup>1719</sup> Investors in funds whose advisers are outside the scope of the final rules, and those funds' advisers, may also benefit, to the extent private fund advisers outside the scope of the rule revise their terms to compete with private fund advisers inside the scope of the rules. As discussed above, private fund adviser fees may currently total in the hundreds of billions of dollars per year.<sup>1720</sup> These two sources of enhanced competition from additional transparency may lead to lower fees or may direct investor assets to different funds, fund advisers, or other investments.

The above pro-competitive effects may also be strengthened by the reduced risks of non-compliance and increased efficiency of the Commission's enforcement and examination of non-compliance resulting from the final amendments to the compliance rule for a written documentation requirement and the amendments to the books and records rule.<sup>1721</sup>

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<sup>1719</sup> See *supra* sections VI.B, VI.D.1.

<sup>1720</sup> See *supra* section VI.C.3.

<sup>1721</sup> See *supra* sections VI.D.7, VI.D.8.

However, certain commenters expressed concerns that there may be negative effects on competition as well. Commenters stated that various individual components of the rule could reduce competition, such as the prohibition on reducing clawbacks for taxes (by delaying performance-based compensation that may increase employee turnover)<sup>1722</sup> and the adviser-led secondary rule to the extent that advisers forgo conducting adviser-led secondaries instead of undertaking the cost of a fairness opinion.<sup>1723</sup> We believe that many of these commenters' concerns have been mitigated by the revisions to the final rules relative to the proposal, such as the exceptions for reducing clawbacks for taxes when certain disclosures are made and the allowance for a valuation opinion instead of a fairness opinion for adviser-led secondaries.

Some commenters also stated restrictions on preferential treatment may reduce co-investment activity,<sup>1724</sup> or may hinder smaller advisers' abilities to secure initial seed or anchor investors.<sup>1725</sup> Commenters argued that smaller, emerging advisers often need to provide anchor investors significant preferential rights.<sup>1726</sup> Other commenters stated broadly that the Proposing Release economic analysis had failed to consider important ways in which the proposed rules may affect competition.<sup>1727</sup>

We believe that the concerns with respect to preferential treatment for smaller advisers will be mitigated in part by the fact that smaller advisers are only prevented from offering anchor

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<sup>1722</sup> AIMA/ACC Comment Letter.

<sup>1723</sup> Comment Letter of the California Alternative Investments Association, Connecticut Hedge Fund Association, New York Alternative Investment Roundtable Inc., Palm Beach Hedge Fund Association, and Southeastern Alternative Funds Association (Apr. 25, 2022) ("CAIA Comment Letter").

<sup>1724</sup> Ropes & Gray Comment Letter.

<sup>1725</sup> *See, e.g.*, Carta Comment Letter; Meketa Comment Letter; Lockstep Ventures Comment Letter; NY State Comptroller Comment Letter.

<sup>1726</sup> *Id.*

<sup>1727</sup> *See, e.g.*, AIC Comment Letter I, Appendix 2; PIFF Comment Letter.

investors preferential redemption rights and preferential information that the advisers reasonably expects to have a material negative effect on other investors. Therefore, these potential harms to competition will be mitigated to the extent that smaller, emerging advisers do not need to be able to offer anchor investors preferential rights that have a material negative effect on other investors to effectively compete, and to the extent that smaller emerging advisers are able to compete effectively by offering anchor investors other types of preferential terms. We have also provided certain legacy status, namely regarding contractual agreements that govern a private fund and that were entered into prior to the compliance date if the rule would require the parties to amend such an agreement, for all advisers under the prohibitions aspect of the preferential treatment rule and all aspects of the restricted activities rule requiring investor consent.<sup>1728</sup> We have lastly included several exceptions from the final rules on preferential treatment, such as an exception from the prohibition on providing certain preferential redemption terms when those terms are offered to all investors.<sup>1729</sup> At the margin, however, some advisers, particularly smaller or emerging advisers, may find it more difficult to compete without offering preferential redemption rights or preferential information that will now be prohibited.

Commenters also stated more generally that increased compliance costs on advisers may reduce competition by causing advisers to close their funds and reducing the choices investors have among competing advisers and funds.<sup>1730</sup> To the extent heightened compliance costs cause

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<sup>1728</sup> See *supra* section IV.

<sup>1729</sup> See *supra* section II.G.

<sup>1730</sup> See, e.g., Weiss Comment Letter; AIC Comment Letter I; AIC Comment Letter I, Appendix 1; AIC Comment Letter I, Appendix 2; MFA Comment Letter II. Some commenters cite to the 2023 Consolidated Appropriations Act, citing, e.g., “an important provision urging the SEC to redo its economic analysis of the Private Fund Adviser proposal to ‘ensure the analysis adequately considers the disparate impact on emerging minority and women-owned asset management firms, minority and women-owned businesses, and historically underinvested communities.’” See, e.g., Comment Letter of Steven Horsford (May 3, 2023); CCMR Comment Letter IV. See also, e.g., *supra* footnotes 1358, 1477, 1555 and accompanying text, and section VI.D.5.



certain advisers to exit, or forgo entry, competition may be reduced. This may particularly occur through the compliance costs associated with mandatory audits, as those costs are likely to fall disproportionately and have a disproportionate impact on funds managed by smaller advisers, and funds advised by smaller advisers facing new increased compliance costs may be among those most likely to exit the market in response to the final rules.<sup>1731</sup> As discussed above, approximately 25% of funds with less than \$2 million in assets under management that are advised by RIAs and will have to undergo an audit as a result of the final rule.<sup>1732</sup>

However, the effects on the smallest advisers will be mitigated where those advisers do not meet the minimum assets under management required to register with the SEC.<sup>1733</sup> Some registered advisers may therefore have the option of reducing their assets under management to forgo registration, thereby avoiding the costs of the final rule that only apply to registered advisers, such as the mandatory audit rule. While advisers responding in this way may negatively affect capital formation,<sup>1734</sup> the option for advisers to respond to the rule in this way may mitigate negative competitive effects, as advisers reducing their size to forgo registration will still leave them as a partial potential competitive alternative to larger advisers (albeit a less effective competitive alternative than they represented as registered advisers).

As discussed above, some commenters also expressed concerns that the loss of smaller advisers would result in reduced diversity of investment advisers, based on an assertion that most

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<sup>1731</sup> See *supra* section VI.D.5.

<sup>1732</sup> See *supra* sections VI.C.4, VI.D.5. Figure 4 illustrates that approximately 4,800 out of almost 6,400 funds of size between \$0 and \$2 million already undergo an audit that will be required by the final rule, leaving approximately 25% of funds of that size that will have to undergo an audit as a result of final rule.

<sup>1733</sup> See *supra* section II.C.

<sup>1734</sup> See *infra* section VI.E.3.

women- and minority-owned advisers are smaller and associated with first time funds.<sup>1735</sup> These commenters' concerns are consistent with industry literature, which finds that, for example, while 7.2% of U.S. private equity firms are women-owned, those firms manage only 1.6% of U.S. private equity assets, indicating that women-owned private equity firms are disproportionately smaller entities.<sup>1736</sup> Similar patterns hold for minority-owned firms and for other types of private funds.<sup>1737</sup> To the extent compliance costs or other effects of the rules cause certain smaller advisers to exit, the rules may result in reduced diversity of investment advisers. The potential reduced diversity of investment advisers may also have downstream effects on entrepreneurial diversity, as minority-owned venture capital and buyout funds are three-to-four times more likely to fund minority entrepreneurs in their portfolio companies.<sup>1738</sup> However, because these effects are strongest for venture capital, these effects may be mitigated wherever an adviser's funds are sufficiently concentrated in venture capital that they may forgo SEC registration and thus forgo many of the costs of the final rules.

As stated above, some commenters stated that the proposed private fund adviser rules and other recently proposed or adopted rules would have interacting effects, and that the effects should not be analyzed independently.<sup>1739</sup> These commenters stated in particular that the combined costs of multiple ongoing rulemakings would harm investors by making it cost-prohibitive for many advisers to stay in business or for new advisers to start a business, and that

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<sup>1735</sup> See *supra* section VI.B; see also, e.g., AIC Comment Letter I, Appendix 1; AIC Comment Letter I, Appendix 2; NAIC Comment Letter.

<sup>1736</sup> See, e.g., KNIGHT FOUNDATION, KNIGHT DIVERSITY OF ASSET MANAGERS RESEARCH SERIES: INDUSTRY (Dec. 7, 2021), available at <https://knightfoundation.org/reports/knight-diversity-of-asset-managers-research-series-industry/>.

<sup>1737</sup> *Id.*

<sup>1738</sup> Johan Cassel, Josh Lerner & Emmanuel Yimfor, *Racial Diversity in Private Capital Fundraising* (Sept. 18, 2022), available at <https://ssrn.com/abstract=4222385>.

<sup>1739</sup> See *supra* section VI.D.1.

this effect would further harm competition by creating new barriers to entry.<sup>1740</sup> As stated above, Commission acknowledges that the effects of any final rule may be impacted by recently adopted rules that precede it.<sup>1741</sup> With respect to competitive effects, the Commission acknowledges that there are incremental effects of new compliance costs on advisers that may vary depending on the total amount of compliance costs already facing advisers and acknowledges costs from overlapping transition periods for recently adopted rules and the final private fund adviser rules.<sup>1742</sup> In particular, the Commission acknowledges these sources of heightened costs from the recent adoption of amendments to Form PF.

To the extent advisers respond to these costs by exiting the market, or by forgoing entry, competition may be negatively affected. In particular, competition may be negatively affected because smaller advisers may be more likely than larger advisers to respond to new compliance costs by exiting or by forgoing entry. To the extent smaller or newer advisers attempt to respond to new compliance costs by passing them on to their funds, this may hinder their ability to compete, as larger advisers may be more able to lower their own profit margins instead of passing some or all of their new costs on to funds and investors.

We have also responded to commenter concerns by providing for a longer transition period for smaller advisers. The costs of having multiple ongoing rulemakings primarily accrue during transition periods, when advisers may have to revise processes, procedures, or fund documents with multiple new rulemakings in mind. In consideration of those costs, we are providing that advisers with less than \$1.5 billion in assets under management will have 18

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<sup>1740</sup> See, e.g., MFA Comment Letter II; MFA Comment Letter III; AIC Comment Letter IV.

<sup>1741</sup> See *supra* section VI.D.1.

<sup>1742</sup> *Id.*

months to comply with the adviser-led secondaries, preferential treatment, and restricted activities rules, compared to the 12 months for larger advisers.<sup>1743</sup> Since smaller advisers are those most likely to either exit the market (or fail to enter) in response to high compliance costs, we believe staggered transition periods that reduce the costs of coming into compliance for advisers reduce the risks of multiple concurrent rulemakings negatively impacting competition. In particular, since the effective date for the new Form PF current reporting is December 11, 2023, the 18-month compliance period means smaller advisers will have over a year after the effective date of Form PF current reporting to come into compliance with the final private fund adviser rules. The legacy status discussed above,<sup>1744</sup> namely regarding contractual agreements that govern a private fund and that were entered into prior to the compliance date if the rule would require the parties to amend such an agreement, for all advisers under the prohibitions aspect of the preferential treatment rule and all aspects of the restricted activities rule requiring investor consent,<sup>1745</sup> is also responsive to commenter concerns on compliance costs. We have lastly responded to commenter concerns on compliance costs by offering certain disclosure-based exceptions and, in some cases, certain consent-based exceptions rather than outright prohibitions.<sup>1746</sup>

To the extent these effects occur, competition may be reduced, but these potential negative effects on competition must be evaluated in light of (1) the other pro-competitive aspects of the final rules, in particular the pro-competitive effects from enhancing transparency,

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<sup>1743</sup> See *supra* section IV.

<sup>1744</sup> See *supra* footnote 1728 and accompanying text.

<sup>1745</sup> See *supra* section IV.

<sup>1746</sup> See *supra* section II.E.

which are likely to help smaller advisers effectively compete and may therefore benefit those advisers,<sup>1747</sup> and (2) the other benefits of the final rules.

### 3. Capital Formation

Commenters emphasized the risks that the rules may reduce capital formation through several different types of arguments. Several commenters made general statements that the high compliance costs of the rule may negatively affect capital formation.<sup>1748</sup> Many of these commenters further specified that the harms to smaller advisers would reduce capital formation.<sup>1749</sup> Some commenters stated that particular aspects of the rule risk reduced capital formation, such as the mandatory audit rule, the charging of regulatory/compliance expenses rule, and the prohibition on limitation of liability rule.<sup>1750</sup> Other commenters stated broadly that the Proposing Release economic analysis had failed to consider important ways in which the proposed rules may affect capital formation.<sup>1751</sup>

While we believe we have resolved certain of these concerns in the final rules, in particular by revising the restricted activities in the final rules relative to the proposal, the final rules still carry a risk that capital formation may be negatively affected. The Proposing Release stated that there may be reduced capital formation associated with the final rules to prohibit

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<sup>1747</sup> To the extent that smaller or newer advisers benefit from these pro-competitive effects, because smaller or newer advisers are disproportionately women-owned and minority-owned, these benefits will therefore disproportionately accrue to women- and minority-owned advisers. *See supra* footnote 1736 and accompanying text.

<sup>1748</sup> *See, e.g.*, AIMA/ACC Comment Letter; Thin Line Comment Letter; ICM Comment Letter; Ropes & Gray Comment Letter; SBAI Comment Letter; AIC Comment Letter I; AIC Comment Letter I, Appendix 2; CAIA Comment Letter; NYPPEX Comment Letter.

<sup>1749</sup> *See, e.g.*, Thin Line Capital Comment Letter; ICM Comment Letter; Ropes & Gray Comment Letter; SBAI Comment Letter.

<sup>1750</sup> Utke and Mason Comment Letter; Convergence Comment Letter; Comment Letter of True Venture (June 14, 2022); Andreessen Comment Letter.

<sup>1751</sup> *See, e.g.*, AIC Comment Letter I, Appendix 2; NYPPEX Comment Letter.

various activities, to the extent that investors currently benefit from those activities.<sup>1752</sup> For example, investors who currently receive preferential terms that will be prohibited under the final rule may withdraw their capital from their existing fund advisers. Those investors may have less total capital to deploy after bearing costs of searching for new investment opportunities, or they may redeploy their capital away from private funds more broadly and into investments with less effective capital formation.

In further response to commenter concerns, we have also reexamined the risks of reduced capital formation in two ways related to the scope of the final rule. In particular, we have examined in two ways how the adviser incentives induced by the boundaries of the scope of the rules may carry unintended consequences of changes to adviser behavior that could risk reducing capital formation.

First, as discussed above, all of the elements of the final rule will in general not apply with respect to non-U.S. private funds managed by an offshore investment adviser, regardless of whether that adviser is registered.<sup>1753</sup> This aspect of the scope of the rule may increase incentives for advisers to move offshore and to limit their activity to non-U.S. private funds. Doing so may reduce U.S. capital formation, to the extent it is more difficult for certain domestic investors, especially more vulnerable investors, to deploy capital to such funds.

Second, the quarterly statements, mandatory audit, and adviser-led secondaries rules will not apply to ERAs.<sup>1754</sup> This aspect of the scope of the rule may increase incentives for advisers to limit their activity in such a way that allows them to forgo registration. In particular, advisers

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<sup>1752</sup> Proposing Release, *supra* footnote 3, at 265-266.

<sup>1753</sup> See *supra* section II.

<sup>1754</sup> *Id.*

may seek to keep their total RAUM under \$150 million or may devote more of their capital to venture fund activity.

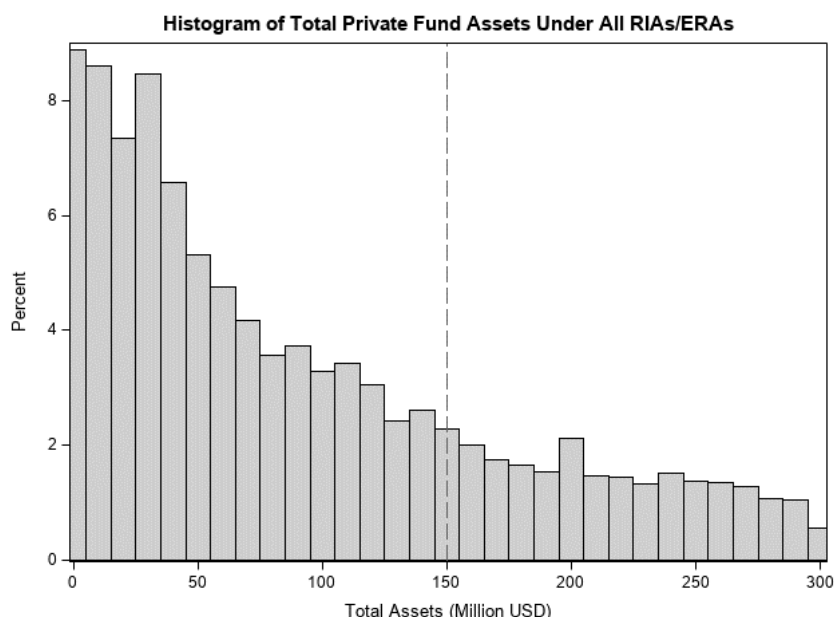
As part of our analysis in response to commenter concerns on risks of reduced capital formation, we have investigated the potential likelihood of advisers responding to differences in RIA and ERA requirements under the final rules by examining how advisers respond to differences in RIA and ERA requirements today. In particular, if there is evidence today that certain private fund advisers respond to different requirements for RIAs and ERAs by avoiding crossing the threshold of \$150 million in private fund assets, we may expect that the increasing differential for RIAs and ERAs under the final rules will, at the margin, impede capital formation by inducing advisers to keep their assets under \$150 million. Figure 8 examines the joint distribution of assets under management by (1) RIAs and (2) ERAs relying on the size exemption for advisers with only private funds and less than \$150 million in RAUM. The figure does not demonstrate any evidence of disproportionately fewer advisers just above the \$150 million threshold compared to the proportion of advisers with less than \$150 million in assets.<sup>1755</sup> This may indicate that it is unlikely that some advisers who would otherwise have had assets between \$150 million and \$200 million will instead seek to stay under the \$150 million threshold. However, because the rule will strengthen the difference in compliance requirements for RIAs and ERAs, the final rule may strengthen this incentive for advisers to keep assets under \$150 million, which may negatively affect capital formation. Any such impact of this mechanism may also be limited by the fact that there are differences in RIA and ERA requirements only for the quarterly statements, mandatory audit, and adviser-led secondaries

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<sup>1755</sup> Rather, the figure demonstrates an approximately continuous downward trend in the proportion of advisers as size increases.

rules, because the restricted activities rules and preferential treatment rules apply to both RIAs and ERAs.

Figure 8:



Source: Form ADV submissions filed between Oct. 1, 2021, and Sept. 30, 2022.

In addition, as discussed above, some advisers to venture capital funds have recently registered as RIAs to be able to have their portfolio allocations outside of direct equity stakes in private companies exceed 20%.<sup>1756</sup> These types of advisers may in the future limit their portfolio allocations outside of direct equity stakes in private companies to forgo registration. Again, the impact of this differential in RIA and ERA requirements may be limited, as it is only driven by the quarterly statements, mandatory audit, and adviser-led secondaries rules, because the restricted activities rules and preferential treatment rules apply to both RIAs and ERAs.

Lastly, certain elements of the rules provide for certain relief to funds of funds. For example, the quarterly statement rule requires advisers to private funds that are not funds of

<sup>1756</sup> See *supra* section VI.C.1.



funds to distribute statements within 45 days after the first three fiscal quarter ends of each fiscal year (and 90 days after the end of each fiscal year), but advisers to funds of funds are allowed 75 days after the first three quarter ends of each fiscal year (and 120 days after fiscal year end).<sup>1757</sup>

However, we also continue to believe the final rules will facilitate capital formation by causing advisers to manage private fund clients more efficiently, by restricting or prohibiting activities that may currently deter investors from private fund investing because they represent possible conflicting arrangements, and by enabling investors to choose more efficiently among funds and fund advisers.<sup>1758</sup>

This may reduce the cost of intermediation between investors and portfolio investments. To the extent this occurs, this may lead to enhanced capital formation in the real economy, as portfolio companies will have greater access to the supply of financing from private fund investors. This may contribute to greater capital formation through greater investment into those portfolio companies.

The final rules may also enhance capital formation through their competitive effects by inducing new fund advisers to enter private fund markets.<sup>1759</sup> To the extent that existing fund advisers reduce their fees to compete more effectively with new entrants, or to the extent that existing pools of capital are redirected to new fund advisers, or fund advisers who have reduced fees to compete, and the advisers receiving redirected capital generate enhanced returns for their investors (for example, advisers who generate larger returns, less correlated returns across

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<sup>1757</sup> See *supra* section II.B.3.

<sup>1758</sup> These and other pro-capital formation effects of the rule may also be strengthened by the reduced risks of non-compliance and increased efficiency of the Commission's enforcement and examination of non-compliance resulting from the final amendments to the compliance rule for a written documentation requirement and the amendments to the books and records rule. See *supra* sections VI.D.7, VI.D.8.

<sup>1759</sup> See *supra* section VI.E.2.

different investment strategies, or returns with more favorable risk profiles), the competitive effects of the final rules may provide new opportunities for capital allocation and potentially spur new investments.

Similarly, the final rules may enhance capital formation by inducing new investors to enter private fund markets. Restricting activities that represent conflicting arrangements, requiring mandatory audits and mandatory fairness or valuation opinions for adviser-led secondaries, and heightened transparency around fee/expense/performance information may increase investor confidence in the safety of their investments.<sup>1760</sup> To the extent investor confidence is heightened, especially for smaller or more vulnerable investors, those investors may increase their willingness to invest their capital. With respect to the final rules on prohibitions for certain preferential information, the Commission has recognized these effects in prior rulemakings. As discussed above, specifically, the Commission has stated that investors in many instances equate the practice of selective disclosure with insider trading, and that the inevitable effect of selective disclosure is that individual investors lose confidence in the integrity of the markets because they perceive that certain market participants have an unfair advantage.<sup>1761</sup> More generally, as discussed above, one academic study found that the passing of regulation requiring advisers to hedge funds to register with the SEC reduced hedge fund misreporting of results to investors, hedge fund misreporting increased on the overturn of that legislation, and that the passing of the Dodd-Frank Act (which removed an exemption from registration on which advisers to hedge funds and other private funds had relied), resulted in higher inflows of capital to hedge funds, indicating that hedge fund investors view regulatory

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<sup>1760</sup> See *supra* sections VI.D.2, VI.D.3, VI.D.4, VI.D.5.

<sup>1761</sup> See *supra* section VI.D.4.

oversight as protecting their interests and that regulatory oversight increases investor confidence and willingness to invest in hedge funds.<sup>1762</sup>

Similarly, and in addition to lower costs of intermediation between investors and portfolio investments, the final rules may directly lower the costs charged by fund advisers to investors by improving transparency over fees and expenses. The final rules may also enhance overall investor returns (for example, as above, larger returns, less correlated returns across different investment strategies, or returns with more favorable risk profiles) by improving transparency over performance information, restricting or prohibiting conflicting arrangements, and requiring external financial statement audits and fairness opinions. To the extent these increased investor funds from lower expenses and enhanced returns are redeployed to new investments, there may be further benefits to capital formation.

## **F. Alternatives Considered**

Several commenters stated their view that the Commission had not considered sufficient alternatives in its proposal.<sup>1763</sup> We believe we have considered many potential alternatives to the final rules. Several of the alternatives considered at proposal, or recommended by commenters,

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<sup>1762</sup> See *supra* section VI.B; see also Stephen G. Dimmock & William Christopher Gerken, *Regulatory Oversight and Return Misreporting by Hedge Funds* (May 7, 2015), available at <https://ssrn.com/abstract=2260058>.

<sup>1763</sup> Citadel Comment Letter; AIMA/ACC Comment Letter; AIC Comment Letter I, Appendix 2. One commenter cites three broad alternatives and criticizes the Proposing Release for not considering them: A “Null Alternative,” a “CLO Exemption Alternative,” and a “Qualified Investor Alternative.”<sup>1763</sup> LSTA Comment Letter, Exhibit C. We disagree with the commenter that the Proposing Release did not consider the Null Alternative, as the Commission’s economic analysis compares costs and benefits relative to the economic baseline, and the economic baseline captures a Null Alternative. See *supra* sections VI.C, VI.D. We also disagree with the commenter that a Qualified Investor Alternative would be a reasonable alternative to consider, as not applying the rule to advisers with respect to funds that can only be accessed by certain investors would have substantial negative consequences such as incentivizing advisers to restrict access to their funds. Moreover, the final rules are designed to protect even sophisticated investors. We have considered the commenter’s CLO Exemption Alternative, and are not applying the five private fund rules to SAF advisers with respect to SAFs they advise. See *supra* section II.

have been implemented as part of the final rules. We have further considered below several alternatives identified by commenters.

# **1. Alternatives to the Requirement for Private Fund Advisers to Obtain an Annual Audit**

First, the Commission could have broadened the application of this rule to, for example, apply to all advisers to private funds, rather than to only advisers to private funds that are registered or required to be registered. Extending the application of the final audit rule to all advisers and in the context of these pooled investment vehicles would increase the benefits of helping investors receive more reliable information from private fund advisers subject to the rule. Investors would, as a result, have greater assurance in both the valuation of fund assets and, because these valuations often serve as the basis for the calculation of the adviser's fees, the fees charged by advisers. However, an extension of the rule to apply to all advisers would likely impose the costs of obtaining audits on smaller funds advised by unregistered advisers. For these types of funds, the cost of obtaining such an audit may be large compared to the value of fund assets and fees and the related value to investors of the required audit, and so this alternative could inhibit entry of new funds, potentially constraining the growth of the private fund market.

Second, instead of broadening the audit rule, we considered narrowing the rule by providing further full or partial exemptions. For example, we could have exempted advisers from obtaining audits for smaller funds or we could exempt an adviser from compliance with the rule where an adviser receives little or no compensation for its services or receives no compensation based on the value of the fund's assets. We could also have exempted advisers to hedge funds and other liquid funds or funds of funds. Further, we could have provided an exemption to advisers from obtaining audits for private funds below a certain asset threshold, for

funds that have only related person investors, or for funds that are below a minimum asset value or have a limited number of investors. Several commenters provided arguments for such exemptions.<sup>1764</sup> Another commenter argued more generally that the entirety of the private fund rulemaking should narrowly focus on private funds with more vulnerable or smaller investors, implicitly arguing for a narrowing of all components of the rule, including the audit rule.<sup>1765</sup>

These exemptions could also have been applied in tandem, for example by exempting only advisers to hedge funds and other liquid funds below a certain asset threshold. For each of these categories, we considered partial instead of full exemptions, for example by requiring an audit only every two (or more) years instead of not requiring any annual audits at all. Further, the benefits of the rule may not be substantial for funds below a minimum asset value, where the cost of obtaining such an audit would be relatively large compared to the value of fund assets and fees that the rule is intended to provide a check on.

We believe, however, that this narrower alternative with the above exemptions to the final audit rule would likely not provide the same investor protection benefits. Many of the investor protection benefits discussed above are specifically associated with the general applicability of the audit rule.<sup>1766</sup> One commenter stated that the time and expense of an audit should be commensurate with the scale of the fund, removing the rationale for exempting smaller advisers.<sup>1767</sup> We also believe that new rules with exemptions for certain types of funds and advisers, in general, distort incentives faced by advisers when determining their desired business model. Exemptions for hedge funds or funds of funds would, at the margin, induce certain

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<sup>1764</sup> See, e.g., PIFF Comment Letter; ILPA Comment Letter I; Ropes & Gray Comment Letter.

<sup>1765</sup> AIC Comment Letter I, Appendix 2.

<sup>1766</sup> See *supra* section VI.D.5.

<sup>1767</sup> See Healthy Markets Comment Letter I.

advisers contemplating launching a private equity fund to instead launch a hedge fund or fund of funds, and we factor in such distortions of incentives into considerations of exemptions for final rules.

Moreover, we have already recognized that some advisers may not have requisite control over a private fund client to cause its financial statements to undergo an audit in a manner that satisfies the mandatory private fund adviser audit rule.<sup>1768</sup> Those advisers will be required under the final rule to take all reasonable steps to cause their private fund clients to undergo an audit. As a final matter, the rule already is only applicable to RIAs and does not apply to ERAs, including those ERAs with less than \$150 million in assets under management in the U.S.<sup>1769</sup>

As a last alternative, instead of requiring an audit as described in the audit rule, we considered requiring that advisers provide other means of checking the adviser's valuation of private fund assets. For example, we considered requiring that an adviser subject to the audit rule provide information to substantiate the adviser's evaluation to its LPAC or, if the fund has no LPAC, then to all, or only significant investors in the fund. We believe that such methods for checking an adviser's methods of valuation would be substantially less expensive to obtain, which could reduce the cost burdens associated with an audit.

However, we believe that these alternatives would likely not accomplish the same investor protection benefits as the audit rule as adopted. As an immediate matter, limiting the requirement in this way would undermine the broader goal of the rule to protect investors against misappropriation of fund assets and providing an important check on the adviser's valuation of private fund assets. We believe, more generally, that these checks would not provide the same

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<sup>1768</sup> See *supra* section II.C.7.

<sup>1769</sup> See *supra* section II.C, VI.D.5.

level of assurance over valuation and, by extension, fees, to fund investors as an audit. As discussed above, we have historically relied on financial statement audits to verify the existence of pooled investment vehicle investments.<sup>1770</sup> Commenters did not address these alternatives, either by expressing support for them or criticizing them, and generally focused their suggestions on either (1) abandoning the audit rule entirely, or (2) narrowing it by providing exemptions.

## **2. Alternatives to the Requirement to Distribute a Quarterly Statement to Investors Disclosing Certain Information Regarding Costs and Performance**

The Commission also considered requiring additional and more granular information to be provided in the quarterly statements that registered investment advisers will be required to provide to investors in private funds. For example, we could have required that these statements include investor-level capital account information, which would provide each investor with means of monitoring capital account levels at regular intervals throughout the year. Because this more specific information would show exactly how fees, expenses, and performance have affected the investor, it could, effectively, further reduce the cost to an investor of monitoring the value of the services the adviser provides to the investor. We believe, however, that requiring capital account information for each investor would substantially increase costs for funds associated with the preparation of these quarterly statements. We do not believe that the policy goals of the rule would be achieved by further increasing the costs of the rule, including potential harms to competition and capital formation.<sup>1771</sup>

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<sup>1770</sup> See *supra* section II.C.

<sup>1771</sup> See *supra* sections VI.D.2, VI.E.

We could also, for example, have required disclosure of performance information for each portfolio investment. For illiquid funds in particular, we could have required advisers to report the IRR for portfolio investments, assuming no leverage, as well as the cash flows for each portfolio investment.<sup>1772</sup> Given the cash flows, end investors could compute other performance metrics, such as PME, for themselves. In addition, this information would give investors means of checking the more general performance information provided in a quarterly statement, and would, further, allow investors to track and evaluate the portfolio investments chosen by an adviser over time. Cash flow disclosures for each portfolio investment would enable an investor to construct measures of performance that address the MOIC's inability to capture the timing of cash flows, avoid the IRR's assumptions on reinvestment rates of early cash flow distributions, and avoid the IRR's sensitivity to cash flows early in the life of the pool.<sup>1773</sup> Investors would also be able to compare performance of individual portfolio investments against the compensation and other data that advisers would be required to disclose for each portfolio investment.<sup>1774</sup>

While we believe that advisers would have cash flow data for each portfolio investment available in connection with the preparation of the standardized fund performance information required to be reported pursuant to the quarterly statement rule, calculating performance

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<sup>1772</sup> For liquid funds, disclosure of performance information for each portfolio investment may be of comparatively lower incremental benefit to investors, because such funds typically have a much larger number of investments. However, investors may have preferences among different liquid funds that depend on more fund outcomes than their total return on their aggregate capital contributions. For example, investors could have a preference for fund advisers whose portfolio investments have returns that are not correlated with each other (meaning portfolio investments with returns that are not disproportionately likely to be similar in magnitude or disproportionately likely to be similar in whether they are positive or negative). A portfolio with correlated returns across investments may, for example, represent lower diversification and greater risk than a portfolio with uncorrelated returns across investments. For investors with such preferences, this alternative could provide similar additional benefits.

<sup>1773</sup> See *supra* section VI.C.3; see, e.g., Harris et al., *supra* footnote 1221; Schoar et al., *supra* footnote 1221.

<sup>1774</sup> See *supra* section II.B.1.b).



information for each portfolio investment could add significant operational burdens and costs. Because these costs would vary based on the number of portfolio investments held by a private fund, such a rule would distort adviser incentives by incentivizing them to take on fewer portfolio investments. The operational burden and cost would also depend on whether the alternative rule required both gross and net performance information for each portfolio investment, which would determine whether the information reflected the impact of fund-level fees and expenses on the performance of each portfolio investment. Requiring both gross and net performance information for each portfolio investment would be of greater use to investors, but would come at a higher operational burden and cost, as providing net performance information would require more complex calculations to allocate fund fees and expenses across portfolio investments. Lastly, to the extent that advisers were required to disclose cash flows for each portfolio investment with and without the impact of fund-level subscription facilities, this calculation may be more burdensome than the single calculation required to make the required fund-level performance information disclosures with and without the impact of fund-level subscription facilities.

As a final granular addition to performance disclosures, the Commission could have required the reporting of a wider variety of performance metrics for hedge funds and other liquid funds, similar to the detailed disclosure requirements for illiquid funds. These could have included requirements for liquid funds to report estimates of fund-level alphas, betas, Sharpe ratios, or other performance metrics. We believe that for investors in liquid funds, absolute returns are of highest priority, and furthermore investors may calculate many of these additional performance metrics themselves by combining fund annual total returns with publicly available data. Commenter concerns also indicate that further standardized required reporting would

continue to raise costs,<sup>1775</sup> but may only provide diminishing marginal benefit. Therefore, we believe these additional reporting requirements would impose additional costs with comparatively little benefit.

As discussed above, one commenter suggested requiring DPI and RVPI instead of MOIC for realized and unrealized investments.<sup>1776</sup> As an initial matter, since the final rules require calculation of unrealized and realized IRR,<sup>1777</sup> we do not believe that DPI and RVPI calculations will be any less incrementally costly than unrealized and realized MOIC, because unrealized and realized MOIC uses the same denominators as unrealized and realized IRR. Moreover, we have discussed above that these metrics may be potentially less effective at highlighting overly optimistic valuations of unrealized investments. This is because the denominator of RVPI includes all paid-in capital, not just capital contributed in respect of unrealized investments, and so the comparatively large denominator in RVPI may dwarf the effect of overvaluations of unrealized investments, while unrealized MOIC may highlight those overvaluations.<sup>1778</sup>

Further, the Commission also considered requiring less information be provided to investors in these quarterly statements. For example, instead of requiring the disclosure of comprehensive fee and expense information, we could have required that advisers disclose only a subset of these, including investments fees and expenses paid by a portfolio company to the adviser. These fees in particular may currently present the biggest burden on investors to track, and requiring the disclosure of only these fees could reduce some costs associated with the effort of compiling, on a quarterly basis, information regarding management fees more generally.

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<sup>1775</sup> See *supra* section VI.D.2.

<sup>1776</sup> See *supra* sections II.B.2, VI.D.2.

<sup>1777</sup> *Id.*

<sup>1778</sup> *Id.*

While we believe some commenters would support such an alternative, based on the lower cost,<sup>1779</sup> we believe if we did not require comprehensive information, investors would not derive the same utility in monitoring fund performance.

We also considered requiring that comprehensive information regarding fees and performance be reported on Form ADV, instead of being disclosed to investors individually. Reporting publicly on Form ADV would continue to allow investors to monitor performance, while also allowing public review of important information about an adviser. One commenter suggested that advisers should be required to report information about borrowing from the fund on Form ADV and Form PF,<sup>1780</sup> and certain other commenters generally supported requiring advisers to make data collected under the rule publicly available.<sup>1781</sup> Disclosure to the Commission, either on Form ADV or Form PF, would provide the Commission with information that would enable the Commission to assess whether there are risks to investors, including risks of misappropriation from a fund. However, because the information required under the rule is tailored to what we believe would serve existing investors in a fund, we believe that direct delivery to investors would better reduce monitoring costs for investors. Further, as discussed above, prospective investors have separate protections, including against misleading, deceptive, and confusing information in advertisements as set forth in the recently adopted marketing rule.<sup>1782</sup>

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<sup>1779</sup> See *supra* section VI.D.2.

<sup>1780</sup> Convergence Comment Letter.

<sup>1781</sup> See, e.g., AFSCME Comment Letter; Comment Letter of National Employment Law Project (Apr. 25, 2022).

<sup>1782</sup> See *supra* section II.B.2.

Instead of requiring disclosure of comprehensive fee and expense information to investors, we considered prohibiting certain fee and expense practices. For example, we could have prohibited charging fees at the fund level in excess of a certain maximum amount that we could determine to be what investors could reasonably anticipate being charged by an adviser. This could, effectively, protect investors from unanticipated charges, and reduce monitoring costs to investors. Further, we could have prohibited certain compensation arrangements, such as the “2 and 20” model or compensation from portfolio investments, to the extent the adviser also receives management fees from the fund. Prohibition of the “2 and 20” model might cause advisers to consider and adopt more efficient models for private fund investing in which the adviser gets a smaller fee and the investor gets a larger share of the gross fund returns, and in which investors are generally better off.<sup>1783</sup> We also considered restricting management fee practices, for example by imposing limitations on sizes of management fees, or requiring management fees to be based on invested capital or net asset value rather than on committed capital. However, the benefits of prohibiting certain fee and expense practices outright would need to be balanced against the costs associated with limiting an adviser and investor’s flexibility in designing fee and expense arrangements tailored to their preferences. There are benefits to flexible negotiations between advisers and investors, and that the final rule should not endeavor to create a rigid private fund contract that governs all possible outcomes of an investment.<sup>1784</sup> We also believe that our policy choice has benefited from taking into consideration the market problem that the policy is designed to address.<sup>1785</sup> We believe that such further prohibitions

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<sup>1783</sup> For example, the compensation model for hedge funds can provide fund advisers with embedded leverage, encouraging greater risk-taking. *See, e.g.,* Brav, et al., *supra* footnote 1427.

<sup>1784</sup> *See supra* section VI.B, VI.D.1; *see also, e.g.,* AIC Comment Letter I, Appendix 1.

<sup>1785</sup> *See supra* section VI.B; *see also, e.g.,* Clayton Comment Letter II.

would too severely restrict the flexibility of negotiations between advisers and investors, and also that such prohibitions would not be tailored to the market problems that this final rule is designed to address.

Similarly, instead of requiring disclosure of comprehensive performance information to investors, we considered prohibiting certain performance disclosure practices. For example, instead of requiring disclosure of performance with and without the effect of fund-level subscription facilities, we considered prohibiting advisers from presenting performance with the effect of such facilities unless they also presented performance without the effect of such facilities. Similarly, we considered prohibiting advisers from presenting combined performance information for multiple funds, such as a main fund and a co-investment fund that pays lower or no fees. Commenters did not generally either support or criticize this alternative. However, while we believe that the required disclosures present the correct standardized, detailed information for investors to be able to evaluate performance, we do not believe there are harms from advisers electing to disclose additional information, and we again believe investors and advisers should have the flexibility to negotiate for that additional information if they believe it would be valuable. As such, we think the benefits of prohibiting any performance disclosure practices would likely be negligible, while there could be substantial costs to investors who value the information that would be prohibited under this alternative.

Finally, the Commission considered broadening the application of this rule to, for example, apply to all advisers to private funds, rather than to only private fund advisers that are registered or required to be registered. Extending the application of the final rule to all advisers would increase the benefits of helping investors receive more detailed and standardized information regarding fees, expenses, and performance. Investors would, as a result, have better

information with which to evaluate the services of these advisers. However, the extension of the final rule to apply to all advisers would likely impose the costs of compiling, preparing, and distributing quarterly statements on smaller funds advised by unregistered advisers. For these types of funds and advisers, these quarterly statement costs may be large compared to the value of fund assets and fees and the related value to investors of the required audit, and thus extending the rule to those advisers would further increase the costs of the rule, potentially increasing any potential harms to competition or capital formation.

### **3. Alternative to the Required Manner of Preparing and Distributing Quarterly Statements and Audited Financial Statements**

The final rules will require private fund advisers to “distribute” quarterly statements and audited annual financial statements to investors in the private fund, and this requirement could be satisfied through either paper or electronic means.<sup>1786</sup> The Commission considered requiring private fund advisers to prepare and distribute the required disclosures electronically using a structured data language, such as the Inline eXtensible Business Reporting Language (“Inline XBRL”).

An Inline XBRL requirement for the disclosures could benefit private fund investors with access to XBRL analysis software by enabling them to more efficiently access, compile, and analyze the disclosures in quarterly statements and audited annual financial statements, facilitating calculations and comparisons of the disclosed information across different time periods or across different portfolio investments within the same time period. For any such private fund investors who receive disclosures from multiple private funds, an Inline XBRL requirement could also facilitate comparisons of the disclosed information across those funds.

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<sup>1786</sup> See *supra* sections II.B.3, II.C.3.

An Inline XBRL requirement for the final disclosures would diverge from the Commission’s other Inline XBRL requirements, which apply to disclosures that are made available to the public and the Commission, thus allowing for the realization of informational benefits (such as increased market efficiency and decreased information asymmetry) through the processing of Inline XBRL disclosures by information intermediaries such as analysts and researchers.<sup>1787</sup> Under the final rules, the required disclosures will not be provided to the public or the Commission for processing and analysis.<sup>1788</sup> Thus, the magnitude of benefit resulting from an Inline XBRL alternative for the disclosure requirements in the final rule may be lower than for other rules with Inline XBRL requirements.<sup>1789</sup>

Compared to the final rule, an Inline XBRL requirement would result in additional compliance costs for private funds and advisers, as a result of the requirement to select, apply, and review the appropriate XBRL U.S. GAAP taxonomy element tags for the required disclosures (or pay a third-party service provider to do so on their behalf). In addition, private fund advisers may not have prior experience with preparing Inline XBRL documents, as neither Form PF nor Form ADV is filed using Inline XBRL. Thus, under this alternative, private funds

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<sup>1787</sup> See, e.g., Y. Cong, J. Hao & L. Zou, *The Impact of XBRL Reporting on Market Efficiency*, 28 J. INFO. SYS. 181 (2014) (finding support for the hypothesis that “XBRL reporting facilitates the generation and infusion of idiosyncratic information into the market and thus improves market efficiency”); Y. Huang, J.T. Parwada, Y.G. Shan & J. Yang, *Insider Profitability and Public Information: Evidence From the XBRL Mandate*, Working Paper (2019) (finding XBRL adoption levels the informational playing field between insiders and non-insiders).

<sup>1788</sup> See *supra* section II.C.6.

<sup>1789</sup> See, e.g., Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts, Investment Company Act Release No. 33814 (Mar. 11, 2020) [85 FR 25964, at 26041 (June 10, 2020)] (stating that an Inline XBRL requirement for certain variable contract prospectus disclosures, which are publicly available, would include informational benefits stemming from use of the Inline XBRL data by parties other than investors, including financial analysts, data aggregators, and Commission staff). While the required disclosures in the final rules would not be provided to the public or the Commission, such benefits would not accrue from an Inline XBRL requirement for the required disclosures.

may incur the initial Inline XBRL implementation costs that are often associated with being subject to an Inline XBRL requirement for the first time (including, as applicable, the cost of training in-house staff to prepare filings in Inline XBRL and the cost to license Inline XBRL filing preparation software from vendors). Accordingly, the magnitude of compliance costs resulting from an Inline XBRL requirement under this final rule may be higher than for other rules with Inline XBRL requirements.

#### **4. Alternatives to the Restrictions from Engaging in Certain Sales Practices, Conflicts of Interest, and Compensation Schemes**

The Commission also considered restricting other activities, in addition to those currently restricted in the final rule. For example, we could have restricted advisers from charging private funds for expenses generally understood to be adviser expenses, such as those incurred in connection with the maintenance and operation of the adviser's business. To the extent that the performance of these activities is outsourced to a consultant, for example, and the fund is charged for that service, advisers may be effectively shifting expenses that would be generally recognized as adviser expenses to instead be fund expenses. The restriction of such charges and the enhancement of disclosures or consent practices around those costs could reduce investor monitoring costs. We believe, however, that identifying the types of charges associated with activities that should never be charged to the fund would likely be difficult. As a result, any such restriction could risk effectively limiting an adviser's ability to outsource certain activities that could be better performed by a consultant, because under the restriction the adviser would not be able to pass those costs on to the fund.

Further, the Commission considered providing an exemption for funds utilizing a pass-through expense model from the restriction on charging fees or expenses associated with certain



examinations, investigations, and regulatory and compliance fees and expenses. This would allow advisers to avoid the costs associated with restructuring any arrangements not compliant with the restriction, including the costs associated with having to make enhanced disclosures of those expenses.<sup>1790</sup> We believe, however, that any exemption would need to be carefully balanced against the risk that it would continue to subject the fund to an adviser's incentive to shift its fees and expenses to the fund to reduce its costs without disclosure to investors.

The Commission also considered requiring consent for all of the restricted activities instead of just investigation expenses and borrowing.<sup>1791</sup> However, we believe there are economic reasons for each of the other restricted activities to not pursue these additional requirements. As discussed above, we believe whether expense pass-through arrangements risk distorting adviser incentives to pay attention to compliance and legal matters may vary from adviser to adviser and may vary according to the type of expense.<sup>1792</sup> For regulatory, compliance, and examination expenses, the risk may be comparatively low, and requiring investor consent or prohibiting the activity altogether may not be necessary. With respect to clawbacks, as many commenters stated, because this practice is widely implemented and negotiated, we do not believe there is a risk of investors being unable, today, to refuse to consent to this practice and being harmed as a result of being unable to consent to this practice.<sup>1793</sup> With respect to non-pro rata allocations of expenses, commenters stated that investors may also often benefit from these co-investment opportunities, or that expenses may be generated

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<sup>1790</sup> See *supra* section II.E.

<sup>1791</sup> *Id.*

<sup>1792</sup> See *supra* sections VI.C.2, VI.D.3.

<sup>1793</sup> See *supra* sections VI.C.2, II.E.1.b).

disproportionately by one fund investing in a portfolio company.<sup>1794</sup> Because these valid reasons for non-pro rata allocations of expenses may occur, a further restriction on non-pro rata allocations of expenses may have substantial unintended negative effects in terms of limiting these valid occurrences of non-pro rata allocations, even when a non-pro rata allocation would be fair and equitable. For example, in the case of an expense generated disproportionately by one fund in a portfolio company, that fund could refuse to consent to being charged greater than a pro rata share of expenses when it could be charged a pro rata share of expenses. In that instance, the consent requirement could result in other funds in the portfolio investment being overcharged.

We lastly considered prohibiting all of the activities outright instead of providing for certain exceptions for when advisers make certain disclosures and, in some cases, also obtain the required investor consent. However, as discussed above, we are convinced by commenters that our concerns with certain of these activities will be substantially alleviated, so long as advisers satisfy the disclosure requirements and, in some cases, consent requirements provided for in the final rules.<sup>1795</sup> We are also convinced by commenters that outright prohibitions would involve substantial indirect costs via unintended consequences of the rules. For example, we are convinced that an outright prohibition of reducing adviser clawbacks for taxes carries a risk of advisers forgoing offering adviser clawbacks altogether, including in circumstances that benefit investors.<sup>1796</sup> We are similarly convinced by comments that the restricted activities can provide bona fide benefits for investors that would be lost under an outright prohibition. For example,

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<sup>1794</sup> See *supra* section VI.C.2.

<sup>1795</sup> See *supra* section II.E.

<sup>1796</sup> See *supra* sections II.E.1.b), VI.D.3.

we are convinced that non-pro rata allocations of fees and expenses in certain cases can still be fair and equitable, if disclosed and if consent is obtained,<sup>1797</sup> and that many advisers borrow from funds to finance activities that are to the benefit of investors.<sup>1798</sup>

**5. Alternatives to the Requirement that an Adviser to Obtain a Fairness Opinion or Valuation Opinion in Connection with Certain Adviser-Led Secondary Transactions**

The Commission also considered changing the scope of the requirement for advisers to obtain a fairness opinion or valuation opinion in connection with adviser-led secondary transactions.

For example, we considered broadening the application of this rule to, for example, apply to all advisers, including advisers that are not required to register as investment advisers with the Commission, such as State-registered advisers and exempt reporting advisers. Under that alternative, investors would receive the assurance of the fairness of more adviser-led secondary transactions. An extension of the final rule to apply to all advisers would, however, likely impose the costs of obtaining fairness opinions or valuation opinions on smaller funds advised by unregistered advisers, and for these types of funds, the cost of obtaining such opinions would likely be relatively large compared to the value of fund assets and fees that the rule is intended to provide a check on. This could discourage those advisers from undertaking these transactions. This could ultimately reduce liquidity opportunities for fund investors.

We also considered consent requirements for the rule, where instead of requiring advisers to obtain a fairness opinion or valuation opinion, advisers would have been required to obtain

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<sup>1797</sup> See *supra* section II.E.1.b).

<sup>1798</sup> See *supra* section II.E.2.b).

investor consent prior to implementing an adviser-led secondary transaction. We considered this alternative because the market friction in these transactions bears certain similarities to the case when advisers borrow from funds, where we are requiring consent: in both cases, the conflict of interest arises because the adviser is on both sides of a transaction.<sup>1799</sup>

However, as discussed in the baseline, unlike the case of adviser borrowing, there is a heightened risk of this conflict of interest distorting the terms or price of the transaction, and it may be difficult for disclosure practices or consent practices alone to resolve these conflicts.<sup>1800</sup> This is because in an adviser-led secondary there may be limited market-driven price discovery processes available to investors. For example, we considered the case where, if a recent sale improperly valued an asset, an adviser could be incentivized to initiate a transaction with the same valuation, which, depending on the terms of the transaction, may benefit the adviser at the expense of the investors. Because of cases like this, and the other cases we have discussed above, we do not consider consent requirements to be a necessary policy choice given the market failure at issue.<sup>1801</sup>

We also considered providing exemptions from the rule. An exemption could be provided where the adviser undertakes a competitive sale process for the assets being sold or for certain advisers to hedge funds or other liquid funds for whom the concerns regarding pricing of illiquid assets may be less relevant. Several commenters requested such exemptions.<sup>1802</sup> These exemptions would reduce the costs on advisers associated with obtaining the fairness opinion or

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<sup>1799</sup> See *supra* section VI.C.4.

<sup>1800</sup> *Id.*

<sup>1801</sup> *Id.*

<sup>1802</sup> See, e.g., Cravath Comment Letter; Carta Comment Letter; ILPA Comment Letter I; IAA Comment Letter II; AIC Comment Letter I.

valuation opinion, which could ultimately reduce costs for investors. However, while this alternative would reduce costs, we believe that any such exemptions could reduce the benefits of the final rule associated with providing greater assurance to investors of the fairness of the transaction. We believe that, even under circumstances where the adviser has conducted a competitive sales process, the effective check on this process provided by the fairness opinion or valuation opinion would benefit investors. Further, even for advisers to hedge funds or other liquid funds who are advising funds with predominantly highly liquid securities, we believe that a fairness opinion or valuation opinion would be beneficial to investors because the conflicts of interest inherent in structuring and leading a transaction may, despite the nature of the assets in the fund, harm investors.<sup>1803</sup>

Some commenters suggested that we expand the final rule to offer additional protections to investors, such as requiring advisers to use reasonable efforts to allow investors to remain invested on their original terms without carry crystallization.<sup>1804</sup> While we agree such an alternative could offer additional protection benefits to investors, those additional protections would continue to increase the costs of the final rule by further requiring advisers to revise their business practices, renegotiate contracts, and undertake additional costly changes to their operations. We believe those costs would not be warranted by the potential benefits.

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<sup>1803</sup> Moreover, the costs to liquid fund advisers are more likely to be limited, as many secondary transactions by liquid funds are not adviser-led (meaning that many such transactions do not involve investors converting or exchanging their interests for new interests in another vehicle advised by the adviser or any of its related persons) and so would not necessitate a fairness opinion.

<sup>1804</sup> *See, e.g.*, RFG Comment Letter II; OPERS Comment Letter.

## **6. Alternatives to the Prohibition from Providing Certain Preferential Terms and Requirement to Disclose All Preferential Treatment**

Instead of requiring that private fund advisers provide investors and prospective investors with written disclosures regarding all preferential treatment the adviser or its related persons provided to other investors in the same fund, the Commission considered prohibiting all such terms. This could provide investors in private funds with increased confidence that the adviser's negotiations with other investors would not affect their investment in the private fund. We preliminarily believe, however, that an outright prohibition of all preferential terms may not provide significant additional benefits beyond prohibitions on providing certain preferential terms regarding redemption or information about portfolio holdings or exposures that would have a material negative effect on other investors. As discussed above, we believe that certain types of preferential terms raise relatively few concerns, if disclosed.<sup>1805</sup> Further, an outright prohibition of all preferential terms may limit the adviser's ability to respond to an individual investor's concerns during the course of attracting capital investments to private funds. Many commenters also expressed, and we agree, that anchor or seed investors may be provided with preferential terms for good reasons.<sup>1806</sup>

Further, we considered prohibiting *all* preferential terms regarding redemption or information about portfolio holdings or exposures, rather than just those that the adviser reasonably expects to have a material, negative effect on other investors in that fund or in a similar pool of assets. This could increase the investor protections associated with the rule, by

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<sup>1805</sup> See *supra* section II.F.

<sup>1806</sup> See, e.g., AIC Comment Letter I; NY State Comptroller Comment Letter; Lockstep Ventures Comment Letter. One commenter also expressed concerns that the limited prohibitions on preferential treatment in the final rules may already impede co-investment activity, and these concerns would be exacerbated by this alternative. See AIC Comment Letter I, Appendix 1.

eliminating the risk that a term not reasonably expected to have a material negative effect on investors could, ultimately, harm investors. We believe, however, that this alternative would likely provide more limited benefits and would increase costs associated with the rule similar to the above alternatives, for example by limiting the adviser's ability to respond to an individual investor's concerns during the course of attracting capital investments to private funds.

In addition, for preferential terms not regarding redemption or information about portfolio holdings or exposures, we considered requiring advisers to private funds to provide disclosure only when the term has a material negative effect on other fund investors. This could reduce the compliance burden on advisers associated with the costs of disclosure. We believe, however, that limiting disclosure to only those terms that an adviser determines to have a material negative effect could reduce an investor's ability to recognize the potential for harm from unforeseen favoritism toward other investors, relative to a requirement to disclose all preferential treatment.

We lastly considered implementing consent requirements, both as an alternative to the prohibition from providing certain preferential terms and as an alternative to the requirement to disclose all preferential treatment. With respect to the prohibition, as we have discussed above, the specific problems we have analyzed may be difficult, or unable, to be addressed via enhanced disclosures or even consent requirements alone. For example, investors facing a collective action problem today, in which they are unable to coordinate their negotiations, would still be unable to coordinate their negotiations even if consent was sought from each individual investor for a particular adviser practice.<sup>1807</sup> With respect to disclosures, in this case we are primarily

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<sup>1807</sup> We also discussed above the example that, in cases where certain preferred investors with sufficient bargaining power to secure preferential terms over disadvantaged investors, majority consent by investor

concerned with how a lack of transparency can prevent investors from understanding the scope or magnitude of preferential terms granted, and as a result, may prevent such investors from requesting additional information on these terms or other benefits that certain investors, receive. In this case, these investors may simply be unaware of the types of contractual terms that could be negotiated and may not face any limitations over their ability to properly consent to these terms or their ability to properly negotiate these terms once the terms are sufficiently disclosed.<sup>1808</sup>

## VII. PAPERWORK REDUCTION ACT

### A. Introduction

Certain provisions of our new rules will result in new “collection of information” requirements within the meaning of the PRA.<sup>1809</sup> The rule amendments will also have an impact on the current collection of information burdens of rules 206(4)-7 and 204-2 under the Advisers Act. The title of the new collection of information requirements we are adopting are “Rule 211(h)(1)-2 under the Advisers Act,” “Rule 206(4)-10 under the Advisers Act,” “Rule 211(h)(2)-2 under the Advisers Act,” and “Rule 211(h)(2)-3 under the Advisers Act.” The Office of Management and Budget (“OMB”) assigned the following control numbers for these new collections of information: Rule 206(4)-10 (OMB control number 3235-0795); Rule 211(h)(1)-2 (OMB control number 3235-0796); Rule 211(h)(2)-2 (OMB control number 3235-0797); Rule 211(h)(2)-3 (OMB control number 3235-0798). The titles for the existing collections of information that we are amending are: (i) “Rule 206(4)-7 under the Advisers Act (17 CFR

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interest requirements may have minimal ability to protect the disadvantaged investors, as we would expect the larger, preferred investors to outvote the disadvantaged investors. *See supra* sections VI.B, VI.C.2.

<sup>1808</sup> *Id.*

<sup>1809</sup> 44 U.S.C. 3501 *et seq.*



275.206(4)-7)” (OMB control number 3235-0585) and (ii) “Rule 204-2 under the Advisers Act (17 CFR 275.204-2)” (OMB control number 3235-0278). The Commission is submitting these collections of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

In addition, the title of the new collection of information requirement we are proposing is “Rule 211(h)(2)-1 under the Advisers Act.” In the Proposing Release, we did not submit a PRA analysis for rule 211(h)(2)-1 because the proposed rule flatly prohibited certain conduct and, accordingly, did not contain a “collection of information” requirement within the meaning of the PRA. However, final rule 211(h)(2)-1 prohibits an adviser from engaging in certain activities, unless the adviser provides certain disclosure to investors, as discussed in greater detail below. In the Proposing Release, we solicited comment on whether rule 211(h)(2)-1 should include disclosure requirements. In response to comments received, we have decided to adopt such a requirement. Accordingly, we are requesting comment on this collection of information requirement, and intend to submit these requirements to the OMB for review under the PRA. Responses to the information collection will not be kept confidential. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

We published notice soliciting comments on the collection of information requirements in the Proposing Release for the other rules and submitted the proposed collections of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. We received general comments to our time and cost burdens stating that we

underestimated the burdens.<sup>1810</sup> We also received comments on aspects of the economic analysis that implicated estimates we used to calculate the collection of information burdens.<sup>1811</sup> We discuss these comments below. We are revising our total burden estimates to reflect the final amendments, updated data, new methodology for certain estimates, and comments we received to our estimates, including comments received to the economic analysis which implicate our estimates.

As discussed above, we are not applying certain of these rules to advisers regarding SAFs they advise.<sup>1812</sup> Thus, for purposes of the PRA analysis, we do not believe that there will be any additional collection of information burden on advisers regarding SAFs.<sup>1813</sup> We have adjusted the estimates from the proposal to reflect that the five private fund rules will not apply to SAF advisers regarding SAFs they advise.

We discuss below the new collection of information burdens associated with final rules 211(h)(1)-2, 206(4)-10, 211(h)(2)-1, 211(h)(2)-2, and 211(h)(2)-3 as well as the revised existing collection of information burdens associated with the amendments to rules 206(4)-7 and 204-2. Responses provided to the Commission in the context of amendments to rules 206(4)-7 and 204-2 will be kept confidential subject to the provisions of applicable law. Because the information

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<sup>1810</sup> See, e.g., CCMR Comment Letter II (stating that the Proposing Release fails to consider how the proposed rules would interact with certain structural factors inherent in the private funds market to produce additional costs for market participants); IAA Comment Letter II (stating that the Commission underestimated the impact of the proposal on investors, advisers, and private funds).

<sup>1811</sup> See, e.g., Comment Letter of Senator Tim Scott and Senator Bill Hagerty (Dec. 14, 2022) (stating that economic analysis of the financial impact on the private funds market grossly underestimates the costs that market participants will incur in order to comply with the Proposal); SIFMA-AMG Comment Letter I.

<sup>1812</sup> See *supra* section II.A (Scope) for additional information. The Commission is not applying all five private fund adviser rules to SAFs advised by SAF advisers.

<sup>1813</sup> Similarly, because we are not applying requirements of these rules to advisers with respect to SAFs they advise, we do not expect that there will be any additional burden on smaller advisers for purposes of the Final Regulatory Flexibility Analysis.

collected pursuant to final rules 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, 206(4)-10, and 211(h)(2)-3 requires disclosures to existing investors and in some cases potential investors, these disclosures will not be kept confidential.

## **B. Quarterly Statements**

Final rule 211(h)(1)-2 requires an investment adviser registered or required to be registered with the Commission to prepare a quarterly statement that includes certain standardized disclosures regarding the cost of investing in the private fund and the private fund's performance for any private fund that it advises, directly or indirectly, that has at least two full fiscal quarters of operating results, and distribute the quarterly statement to the private fund's investors, unless such a quarterly statement is prepared and distributed by another person.<sup>1814</sup> If the private fund is not a fund of funds, then the quarterly statement must be distributed within 45 days after the end of each of the first three fiscal quarters of each fiscal year and 90 days after the end of each fiscal year. If the private fund is a fund of funds, then a quarterly statement must be distributed within 75 days after the first, second, and third fiscal quarter ends and 120 days after the end of the fiscal year of the private fund. The quarterly statement will provide investors with fee and expense disclosure for the prior quarterly period or, in the case of a newly formed private fund initial account statement, its first two full fiscal quarters of operating results. It will also provide investors with certain performance information depending on whether the fund is categorized as a liquid fund or an illiquid fund.<sup>1815</sup>

The collection of information is necessary to provide private fund investors with information about their private fund investments. The quarterly statement is designed to allow a

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<sup>1814</sup> See final rule 211(h)(1)-2.

<sup>1815</sup> See final rule 211(h)(1)-2(d).

private fund investor to compare standardized cost and performance information across its private fund investments. We believe this information will help inform investment decisions, including whether to remain invested in certain private funds or to invest in other private funds managed by the adviser or its related persons. More broadly, this disclosure will help inform investors about the cost and performance dynamics of this marketplace and potentially improve efficiency for future investments.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a “collection of information” requirement under the PRA. This collection of information is found at 17 CFR 275.211(h)(1)-2 and is mandatory. The respondents to these collections of information requirements will be investment advisers that are registered or required to be registered with the Commission that advise one or more private funds.

Based on Investment Adviser Registration Depository (IARD) data, as of December 31, 2022, there were 15,361 investment advisers registered with the Commission.<sup>1816</sup> According to this data, 5,248 registered advisers provide advice to private funds.<sup>1817</sup> We estimate that these advisers, on average, each provide advice to 10 private funds.<sup>1818</sup> We further estimate that these private funds, on average, each have a total of 80 investors.<sup>1819</sup> As a result, an average private fund adviser has, on average, a total of 800 investors across all private funds it advises. As noted above, because the information collected pursuant to final rule 211(h)(1)-2 requires disclosures to private fund investors, these disclosures will not be kept confidential.

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<sup>1816</sup> Excluding advisers that provide advice solely to SAFs, there were 15,288 investment advisers registered with the Commission.

<sup>1817</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1). The final rule will not apply to SAF advisers with respect to SAFs they advise. These figures do not include SAF advisers that manage only SAFs.

<sup>1818</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1). The final rule will not apply to SAFs. These figures do not include SAFs.

<sup>1819</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).A., #13.

Some commenters highlighted the potential costs of the required quarterly statements.<sup>1820</sup> One commenter generally criticized the hours estimates underlying cost estimates in the Proposing Release as unsupported, arbitrary, and possibly underestimated.<sup>1821</sup> One commenter stated that the introduction of the new regulatory terms that will only be used for complying with the performance reporting requirements under the quarterly statement rule would likely lead to additional compliance burdens and costs for private fund advisers, and that adopting new terms would require private funds to conduct an additional analysis and categorization of their private funds, which would need to be reviewed and potentially reevaluated from time to time.<sup>1822</sup> This commenter also stated that gathering information regarding covered portfolio investments would materially increase compliance burdens and costs to produce such information in adherence with the proposed timing and content requirements.<sup>1823</sup> Another commenter asserted that the Proposing Release failed to take account of the full extent of the likely costs associated with its disclosure requirements.<sup>1824</sup> Specifically, this commenter argued that there could be other costs beyond simply complying with the administrative aspects of the quarterly statement rule and that the Proposing Release fails to consider the operational burden imposed by the frequency and timing of the required reports.<sup>1825</sup>

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<sup>1820</sup> See, e.g., Alumni Ventures Comment Letter; Segal Marco Comment Letter; Roubaix Comment Letter; ATR Comment Letter; AIC Comment Letter I.

<sup>1821</sup> See AIC Comment Letter I, Appendix I (stating that the Commission's wage rates used to quantify costs may be underestimated); *But see* LSTA Comment Letter, Exhibit C (stating that the Commission's wage rates are conservatively high and the commenter used a lower wage rate provided by the Bureau of Labor Statistics in its analysis). See also *supra* section VI.D.2 (discussing the Commission's attempts to quantify costs accurately).

<sup>1822</sup> See SIFMA-AMG Comment Letter I.

<sup>1823</sup> *Id.*

<sup>1824</sup> See CCMR Comment Letter I.

<sup>1825</sup> *Id.*

We were persuaded by commenters who asserted that the proposed burdens underestimated the time and expense associated with the proposed quarterly statement rule. We believe that it will take more time than initially contemplated in the proposal to collect the applicable data, perform and review calculations, prepare the quarterly statements, and distribute them to investors. To address commenters' concerns, and recognizing the changes from the proposal discussed above in Section II.B (Quarterly Statements), we are revising the estimates upwards as reflected in the chart below. For instance, to address one commenter's contention that we underestimated the burdens generally, and recognizing the changes from the proposal, we are revising the internal initial burden for the preparation of the quarterly statement estimate upwards to 12 hours. We believe this is appropriate because advisers will likely need to develop, or work with service providers to develop, new systems to collect and prepare the statements. We have also adjusted these estimates to reflect that the final rule will not apply to SAF advisers with respect to SAFs they advise.

We have made certain estimates of this data solely for this PRA analysis. The table below summarizes the initial and ongoing annual burden estimates associated with the final quarterly statement rule.

**Table 1: Rule 211(h)(1)-2 PRA Estimates**

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
ESTIMATES					

Preparation of account statements	12 hours	14 hours <sup>2</sup> (See FN for calculation)	\$436 (blended rate for compliance attorney (\$425), assistant general counsel (\$543), and financial reporting manager (\$339))	\$6,104  (Internal annual burden times blended wage rate)	\$4,590 <sup>3</sup>  (See FN for calculation)
Distribution of account statements to existing investors	3 hours	5 hours <sup>4</sup> (See FN for calculation)	\$73 (rate for general clerk)	\$365  (Internal annual burden times wage rate)	\$1,059 <sup>5</sup>  (See FN for calculation)
Total new annual burden per private fund		19 hours		\$6,469	\$5,649
Avg. number of private funds per adviser		10 private funds		10 private funds	10 private funds
Number of PF advisers		5,248 advisers		5,248 advisers	2,624 <sup>6</sup>
Total new annual burden		997,120 hours		\$339,493,120	\$148,229,760

Notes:

1. The hourly wage rates in these estimates are based on (1) SIFMA's *Management & Professional Earnings in the Securities Industry 2013*, modified by SEC staff to account for an 1,800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead; and (2) SIFMA's *Office Salaries in the Securities Industry 2013*, modified by SEC staff to account for an 1,800-hour work-year and inflation, and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead. The final estimates are based on the preceding SIFMA data sets, which SEC staff have updated since the Proposing Release to account for current inflation rates.

2. This includes the internal initial burden estimate annualized over a three-year period, plus 10 hours of ongoing annual burden hours and takes into account that there will be four statements prepared each year. The estimate of 14 hours is based on the following calculation: ((12 initial hours / 3 years) + 10 hours of additional ongoing burden hours) = 14 hours.

3. This estimated burden is based on the sum of the estimated wage rate of \$565/hour, for 5 hours, (\$2,825) for outside legal services and the estimated wage rate of \$353/hour, for 5 hours, (\$1,765) for outside accountant assistance, and it assumes that there will be four statements prepared each year. The Commission's estimates of the relevant wage rates for external time costs, such as outside legal services, take into account staff experience, a variety of sources including general information websites, and adjustments for inflation.

4. This includes the internal initial burden estimate annualized over a three-year period, plus 4 hours of ongoing annual burden hours that takes into account that there will be four statements prepared each year. The estimate of 5 hours is based on the following calculation: ((3 initial hours / 3 years) + 4 hours of additional ongoing burden hours) = 5 hours.

5. This estimated burden is based on the estimated wage rate of \$353/hour, for 3 hours, for outside accounting services, and it assumes that there will be four statements distributed each year. See *supra* endnote 1 (regarding wage rates with respect to external cost estimates).

6. We estimate that 50% of advisers will use outside legal and accounting services for these collections of information. This estimate takes into account that advisers may elect to use these outside services (along with in-house counsel), based on factors such as adviser budget and the adviser's standard practices for using such outside services, as well as personnel availability and expertise.

### C. Mandatory Private Fund Adviser Audits

Final rule 206(4)-10 will require investment advisers that are registered or required to be registered to cause each private fund they advise, directly or indirectly, to undergo a financial statement audit in accordance with the audit provision (and related requirements for delivery of audited financial statements) under the custody rule.<sup>1826</sup> We believe that final rule 206(4)-10 will protect the fund and its investors against the misappropriation of fund assets and that an audit performed by an independent public accountant will provide an important check on the adviser's valuation of private fund assets, which generally serve as the basis for the calculation of the adviser's fees. The collection of information is necessary to provide private fund investors with information about their private fund investments.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a "collection of information" requirement under the PRA. This collection of information is found at 17 CFR 275.206(4)-10 and is mandatory to the extent the adviser provides investment advice to a private fund. The respondents to these collections of information requirements will be investment advisers that are registered or required to be registered with the Commission that advise one or more private funds. All responses required by the audit rule would be mandatory. One response type (the audited financial statements) would be distributed only to investors in the private fund and would not be confidential.

Based on IARD data, as of December 31, 2022, there were 15,361 investment advisers registered with the Commission.<sup>1827</sup> According to this data, 5,248 registered advisers, excluding

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<sup>1826</sup> See final rule 206(4)-10. The rule also requires an adviser to *take all reasonable steps* to cause its private fund client to undergo an audit that satisfies the rule when the adviser does not control the private fund and is neither controlled by nor under common control with the fund.

<sup>1827</sup> Excluding advisers that provide advice solely to SAFs, there were 15,288 investment advisers registered with the Commission.



advisers managing solely SAFs, provide advice to private funds.<sup>1828</sup> We estimate that these advisers, on average, each provide advice to 10 private funds, excluding SAFs.<sup>1829</sup> We further estimate that these private funds, excluding SAFs, each have a total of 80 investors, on average.<sup>1830</sup> As a result, an average private fund adviser would have, on average, a total of 800 investors across all private funds it advises.

One commenter generally criticized the hours estimates underlying the cost estimates in the Proposing Release as unsupported, arbitrary, and possibly underestimated.<sup>1831</sup> Several commenters highlighted the costs associated with the audit rule, stating that it would substantially increase audit prices because, for example, there may be an insufficient number of suitable auditors available.<sup>1832</sup> One commenter asserted that the Commission failed to provide an adequate justification or backup in its analysis.<sup>1833</sup> This commenter argued that the cost estimate is underestimated by at least 100 percent.

We have made certain estimates of this data, as discussed below, solely for this PRA analysis. The table below summarizes the initial and ongoing annual burden estimates associated with the proposed rule's reporting requirement. We have adjusted this estimate upwards from the proposal to reflect the final rule, updated data, new methodology for certain estimates, and comments we received to our estimates asserting that we underestimated these figures in the proposal. We have further adjusted these estimates to reflect that the final rule will not apply to SAF advisers with respect to SAFs they advise.

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<sup>1828</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>1829</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>1830</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).A., #13.

<sup>1831</sup> See AIC Comment Letter I.

<sup>1832</sup> See, e.g., AIC Comment Letter I; AIMA/ACC Comment Letter; SBAI Comment Letter.

<sup>1833</sup> See, e.g., LSTA Comment Letter.

**Table 2: Rule 206(4)-10 PRA Estimates**

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
ESTIMATES					
Distribution of audited financial statements <sup>2</sup>	0 hours	1.33 hours <sup>3</sup>	\$175 (blended rate for intermediate accountant (\$200), general accounting supervisor (\$252), and general clerk (\$73))	\$232.75	\$75,000 <sup>4</sup>
Total new annual burden per private fund		1.33 hours		\$232.75	\$75,000 <sup>5</sup>
Avg. number of private funds per adviser		10 private funds		10 private funds	10 private funds
Number of advisers		5,248 advisers		5,248 advisers	5,248 advisers
Total new annual burden		69,798.4 <sup>6</sup> hours		\$12,214,720 <sup>6</sup>	\$3,936,000,000 <sup>6</sup>

Notes:

1. See SIFMA data sets *supra* Note 1 to Table 1 Rule 211(h)(1)-2 PRA Estimates.

2. The audit provision will require an adviser to obtain an audit at least annually and upon an entity's liquidation. To the extent not prohibited, we anticipate that, in some cases, the fund will bear the audit expense, in other cases the adviser will bear it, and in other instances both the adviser and fund will share the expense. The liquidation audit would serve as the annual audit for the fiscal year in which it occurs. See rule 206(4)-10.

3. This estimate takes into account that the financial statements must be distributed once annually under the audit rule and that a liquidation audit would replace a final audit in a year. Based on our experience under the custody rule, we estimate the hour burden imposed on the adviser relating to the distribution of the audited financial statements with respect to the investors in each fund should be minimal, approximately one minute per investor. See 2009 Custody Rule Release, *supra* footnote 510, at 63.

4. Based on our experience, we estimate that the party (or parties) that bears the audit expense would pay an average audit fee of \$75,000 per fund. We estimate that individual fund audit fees would tend to vary over an estimated range from \$15,000 to \$300,000, and that some fund audit fees would be higher or lower than this range. We understand that the price of the audit has many variables, such as whether it is a liquid fund or illiquid fund, the number of its holdings, availability of a PCAOB registered and inspected auditor, economies of scale, and the location and size of the auditor.

5. We assume the same frequency of these cost estimates as for the internal annual burden hours estimate.

6. Based on Form ADV data, apart from SAFs approximately 88% of private fund advisers already cause their private funds to undergo a financial statement audit. See Section VI (Economic Analysis – Economic Baseline – Fund Audits). Accordingly, we expect the incremental burdens associated with the rule to be substantially lower than the figures reflected herein.

#### **D. Restricted Activities**

Final rule 211(h)(2)-1 prohibits all private fund advisers from, directly or indirectly, engaging in the following activities, unless they provide written disclosure to investors and, in some cases, obtain investor consent regarding such activities: charging the private fund for fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority (other than 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 Investment Advisers Act of 1940 or the rules promulgated thereunder); charging the private fund for any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the adviser or its related persons; reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders; charging or allocating fees and expenses related to a portfolio investment on a non-pro rata basis when more than one private fund or other client advised by the adviser or its related persons have invested in the same portfolio company; and borrowing money, securities, or other private fund assets, or receiving a loan or extension of credit, from a private fund client.

As noted above, in the Proposing Release we did not submit a PRA analysis for rule 211(h)(2)-1 because the proposed rule flatly prohibited certain conduct and, accordingly, proposed rule 211(h)(2)-1 did not contain a “collection of information” requirement within the meaning of the PRA. However, final rule 211(h)(2)-1 prohibits an adviser from engaging in certain activity, unless the adviser provides certain disclosure to investors. Accordingly, we are requesting comment on this collection of information requirement in this release and intend to submit these requirements to the OMB for review under the PRA.

The collection of information is necessary to provide private fund investors with information about their private fund investments. We believe that many advisers fail to provide disclosure of the activities covered by the restrictions or, when disclosure is provided, it is often insufficient.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a “collection of information” requirement under the PRA. This collection of information is found at 17 CFR 275.211(h)(2)-1 and is mandatory if the adviser engages in the restricted activity. The respondents to these collections of information requirements would be all investment advisers that advise one or more private funds. Based on IARD data, as of December 31, 2022, there were 12,234 investment advisers (including both registered and unregistered advisers, but excluding advisers managing solely SAFs) that provide advice to private funds.<sup>1834</sup> We estimate that these advisers, on average, each provide advice to 8 private funds (excluding SAFs). We further estimate that these private funds would, on average, each have a total of 63 investors. As a result, an average private fund adviser would have a total of 504 investors across all private funds it advises. As noted above, because the information collected pursuant to final rule 211(h)(2)-1 requires disclosures to private fund investors, these disclosures would not be kept confidential.

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<sup>1834</sup> The following types of private fund advisers (excluding advisers managing solely SAFs), among others, would be subject to the rule: unregistered advisers (*i.e.*, advisers that may be prohibited from registering with us), foreign private advisers, and advisers that rely on the intrastate exemption from SEC registration and/or the *de minimis* exemption from SEC registration. However, we are unable to estimate the number of advisers in certain of these categories because these advisers do not file reports or other information with the SEC and we are unable to find reliable, public information. As a result, the above estimate is based on information from SEC-registered advisers to private funds, exempt reporting advisers (at the State and Federal levels), and State-registered advisers to private funds, in each instance excluding advisers that manage solely SAFs. These figures are approximate, exclude in each instance advisers that manage solely SAFs, and assume that all exempt reporting advisers are advisers to private funds. The breakdown is as follows: 5,248 SEC-registered advisers to private funds; 5,234 exempt reporting advisers (at the Federal level); 562 State-registered advisers to private funds; and 1,922 State exempt reporting advisers.

We have made certain estimates of this data solely for this PRA analysis. The table below summarizes the initial and ongoing annual burden estimates associated with the rule. We request comment on whether the estimates associated with the new collection of information requirements in “Rule 211(h)(2)-1 under the Advisers Act” are reasonable in Section VII.I below.

**Table 3: Rule 211(h)(2)-1 PRA Estimates**

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
PROPOSED ESTIMATES					
Preparation of written notices and consents	12 hours	8 hours <sup>2</sup>	\$ 422 (blended rate for compliance attorney (\$425), accounting manager (\$337), senior portfolio manager (\$383) and assistant general counsel (\$543))	\$3,376	\$3,178 <sup>3</sup>
Provision, distribution, collection, retention, and tracking of written notices and consents	6 hours	4 hours <sup>4</sup>	\$73 (rate for general clerk)	\$292	
Total new annual burden per private fund		12 hours		\$3,668	\$3,178
Avg. number of private funds per adviser		8 private funds		8 private funds	8 private funds
Number of advisers		12,234 advisers		12,234 advisers	9,176 advisers <sup>5</sup>

Total new annual burden		1,174,464 hours		\$ 358,994,496	\$233,290,624
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Notes:

1. See SIFMA data sets, *supra* Note 1 to Table 1 Rule 211(h)(1)-2 PRA Estimates.
2. This includes the internal initial burden estimate annualized over a three-year period, plus 4 hours of ongoing annual burden hours and assumes notices and consent forms would be issued once a quarter to investors. The estimates assume that most private fund advisers will rely on the disclosure-based or investor consent exceptions to the rules and thus distribute written notices and consent forms to investors (and collect, retain, and track consent forms); however, the estimates also take into account that certain fund agreements may not permit or otherwise contemplate the activity restricted by the rule (e.g., liquid funds may not contemplate an adviser clawback of performance compensation) and, accordingly, the estimates take into account that advisers to those funds will not prepare written notices (or, if applicable, prepare, collect, retain, and track consent forms) as contemplated by the rule. The estimate of 8 hours is based on the following calculation: ((12 initial hours / 3 years) + 4 hours of additional ongoing burden hours) = 8 hours.
3. This estimated burden is based on the estimated wage rate of \$565/hour, for 5 hours, for outside legal services and \$353/hour, for one hour, for outside accounting services, at the same frequency as the internal burden hours estimate. The Commission's estimates of the relevant wage rates for external time costs, such as outside legal services, take into account staff experience, a variety of sources including general information websites, and adjustments for inflation.
4. This includes the internal initial burden estimate annualized over a three-year period, plus 2 hours of ongoing annual burden hours. The estimate of 4 hours is based on the following calculation: ((6 initial hours / 3 years) + 2 hours of additional ongoing burden hours) = 4 hours.
5. We estimate that 75% of advisers will use outside legal services for these collections of information. This estimate takes into account that advisers may elect to use outside legal services (along with in-house counsel), based on factors such as adviser budget and the adviser's standard practices for using outside legal services, as well as personnel availability and expertise.

## E. Adviser-Led Secondaries

Final rule 211(h)(2)-2 requires an adviser registered or required to be registered with the Commission that is conducting an adviser-led secondary transaction to distribute to investors a fairness opinion or valuation opinion from an independent opinion provider and a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider.<sup>1835</sup> This requirement provides an important check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors and helps ensure that private fund investors are offered a fair price for their private fund interests. Specifically, this requirement is designed to help ensure that investors receive the benefit of an independent price assessment, which we believe will improve their decision-making ability and their overall

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<sup>1835</sup> See final rule 211(h)(2)-2.

confidence in the transaction. The collection of information is necessary to provide investors with information about securities transactions in which they may engage.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a “collection of information” requirement under the PRA. This collection of information is found at 17 CFR 275.211(h)(2)-2 and is mandatory. The respondents to these collections of information requirements will be investment advisers that are registered or required to be registered with the Commission that advise one or more private funds. Based on IARD data, as of December 31, 2022, there were 15,361 investment advisers registered with the Commission.<sup>1836</sup> According to this data, 5,248 registered advisers provide advice to private funds.<sup>1837</sup> Of these 5,248 advisers, we estimate that 10%, or approximately 525 advisers, conduct an adviser-led secondary transaction each year. Of these advisers, we further estimate that each conducts one adviser-led secondary transaction each year. As a result, an adviser will have obligations under the rule with regard to 80 investors.<sup>1838</sup> As noted above, because the information collected pursuant to final rule 211(h)(2)-2 requires disclosures to private fund investors, these disclosures will not be kept confidential.

One commenter generally criticized the hours estimates underlying the cost estimates in the Proposing Release as unsupported, arbitrary, and possibly underestimated.<sup>1839</sup> Some

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<sup>1836</sup> Excluding advisers that provide advice solely to SAFs, there were 15,288 investment advisers registered with the Commission.

<sup>1837</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1). The final rule will not apply to SAF advisers with respect to SAFs they advise. These figures do not include SAF advisers that manage only SAFs.

<sup>1838</sup> See *supra* section VII.B.

<sup>1839</sup> See AIC Comment Letter I. Another commenter’s calculation of aggregate costs associated with the adviser-led secondaries rule yields substantially higher aggregate costs, but per-fund costs comparable to those reflected here. The commenter’s aggregate cost result is driven by the commenter assuming, without basis or discussion, that the adviser-led secondaries rule’s costs will be borne over 4,533 fairness opinions instead of 504, as was assumed by the Proposing Release. See LSTA Comment Letter, Exhibit C. We

commenters asserted that the Commission’s estimate of the cost for a fairness opinion was likely too low in light of available information on fairness opinions.<sup>1840</sup> However, many of these commenters stated that a valuation opinion would likely be less costly in most circumstances.<sup>1841</sup> We believe that these commenters’ concerns on costs are substantially mitigated by the option in the final rule for a valuation opinion instead of a fairness opinion; however, we have adjusted the estimates upwards to address comments received, which generally stated that the proposed estimate underestimated the cost of fairness opinions.<sup>1842</sup> We have also adjusted this estimate upwards from the proposal to reflect the final rule and updated data for certain estimates. We have adjusted these estimates to reflect that the final rule will not apply to SAF advisers with respect to SAFs they advise.

We have made certain estimates of this data solely for this PRA analysis. The table below summarizes the annual burden estimates associated with the rule’s requirements.

**Table 4: Rule 211(h)(2)-2 PRA Estimates**

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
ESTIMATES					

believe this to be an error in the commenter’s analysis and have continued to assume approximately 10 percent of advisers conduct an adviser-led secondary transaction each year. *See supra* section VI.D.6.

<sup>1840</sup> *See* AIC Comment Letter I; Houlihan Comment Letter; MFA Comment Letter I; MFA Comment Letter I, Appendix A; Ropes & Gray Comment Letter.

<sup>1841</sup> MFA Comment Letter I; MFA Comment Letter I, Appendix A; AIC Comment Letter I.

<sup>1842</sup> *See* Houlihan Comment Letter; LSTA Comment Letter.



Preparation/Procurement of fairness or valuation opinion	0 hours	10 hours <sup>2</sup>	\$429.33 (blended rate for compliance attorney (\$425), assistant general counsel (\$543), and senior business analyst (\$320))	\$4,293.30	\$100,000 <sup>3</sup>
Preparation of material business relationship summary	0 hours	2 hours	\$484 (blended rate for compliance attorney (\$425) and assistant general counsel (\$543))	\$968	\$565 <sup>4</sup>
Distribution of fairness/valuation opinion and material business relationship summary	0 hours	1 hour	\$73 (rate for general clerk)	\$73	\$0
Total new annual burden per private fund		13 hours		\$5,334.30	\$100,565
Number of advisers		525 advisers <sup>5</sup>		525 advisers	525 advisers
Total new annual burden		6,825 hours		\$2,800,507.50	\$52,796,625

Notes:

1. See SIFMA data sets *supra* Note 1 to Table 1 Rule 211(h)(1)-2 PRA Estimates.

2. Includes the time an adviser will spend gathering materials to provide to the independent opinion provider so that the latter can prepare the fairness or valuation opinion.

3. This estimated burden is based on our understanding of the general cost of a fairness/valuation opinion in the current market. The cost will vary based on, among other things, the complexity, terms, and size of the adviser-led secondary transaction, as well as the nature of the assets of the fund.

4. This estimated burden is based on the estimated wage rate of \$565/hour, for 1 hour, for outside legal services at the same frequency as the internal burden hours estimate. The Commission's estimates of the relevant wage rates for external time costs, such as outside legal services, take into account staff experience, a variety of sources including general information websites, and adjustments for inflation.

5. We estimate that 10% of all registered private fund advisers conduct an adviser-led secondary transaction each year.

## **F. Preferential Treatment**

Final rule 211(h)(2)-3 prohibits all private fund advisers from providing preferential terms to investors regarding certain redemptions or providing certain information about portfolio holdings or exposures, subject to certain limited exceptions.<sup>1843</sup> The rule also prohibits these advisers from providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund. For prospective investors, the new rule requires advisers to provide the written notice regarding any preferential treatment related to any all material economic terms prior to an investor's investment in the fund.<sup>1844</sup> The final rule also requires advisers to provide investors with comprehensive annual disclosure of all preferential treatment provided by the adviser or its related persons since the last annual notice. The final rule requires the adviser to distribute to current investors an initial notice of such preferential treatment (i) for an illiquid fund, as soon as reasonably practicable following the end of the fund's fundraising period and (ii) for a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund.

The new rule is designed to protect investors and serve the public interest by requiring disclosure of preferential treatment afforded to certain investors. The new rule will increase transparency to better inform investors regarding the breadth of preferential terms, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms. Also, this disclosure will help

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<sup>1843</sup> See final rule 211(h)(2)-3(b).

<sup>1844</sup> See final rule 211(h)(2)-3(b)(1).

investors shape the terms of their relationship with the adviser of the private fund. The collection of information is necessary to provide private fund investors with information about their private fund investments.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a “collection of information” requirement under the PRA. This collection of information is found at 17 CFR 275.211(h)(2)-3 and is mandatory. The respondents to these collections of information requirements will be all investment advisers that advise one or more private funds. Based on IARD data, as of December 31, 2022, there were 12,234 investment advisers (including both registered and unregistered advisers, but excluding advisers managing solely SAFs) that provide advice to private funds.<sup>1845</sup> We estimate that these advisers, on average, each provide advice to 8 private funds (excluding SAFs). We further estimate that these private funds, on average, each have a total of 63 investors. As a result, an average private fund adviser has a total of 504 investors across all private funds it advises. As noted above, because the information collected pursuant to rule 211(h)(2)-3 requires disclosures to private fund investors and prospective investors, these disclosures will not be kept confidential.

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<sup>1845</sup> The following types of private fund advisers (excluding advisers managing solely SAFs), among others, will be subject to the rule: unregistered advisers (*i.e.*, advisers those that may be prohibited from registering with us), foreign private advisers, and advisers that rely on the intrastate exemption from SEC registration and/or the *de minimis* exemption from SEC registration. However, we are unable to estimate the number of advisers in certain of these categories because these advisers do not file reports or other information with the SEC and we are unable to find reliable, public information. As a result, the above estimate is based on information from SEC-registered advisers to private funds, exempt reporting advisers (at the State and Federal levels), and State-registered advisers to private funds. These figures are approximate, exclude in each instance advisers that manage solely SAFs, and assume that all exempt reporting advisers are advisers to private funds. The breakdown is as follows: 5,248 SEC-registered advisers to private funds; 5,234 exempt reporting advisers (at the Federal level); 562 State-registered advisers to private funds; and 1,922 State exempt reporting advisers.

One commenter generally criticized the hours estimates underlying the cost estimates in the Proposing Release as unsupported, arbitrary, and possibly underestimated.<sup>1846</sup> Another commenter emphasized that existing fund documents would need to be amended to come into compliance with the proposed rules and that the release fails to identify or quantify the transaction costs associated with the renegotiation of fund documents.<sup>1847</sup> Another commenter made a similar argument, asserting that, without a legacy status provision for existing relationships, the proposed changes likely will require advisers to renegotiate agreements with investors and that proposal significantly underestimates the costs of the proposals on existing private funds.<sup>1848</sup>

We have adjusted this estimate upwards from the proposal to reflect the final rule (including with respect to the exceptions in paragraph (a) of the final rule), updated data, new methodology for certain estimates, and comments we received to our estimates asserting that we underestimated these figures in the proposal. We have also adjusted these estimates to reflect that the final rule will not apply to SAF advisers with respect to SAFs they advise.

We have made certain estimates of this data solely for this PRA analysis. The table below summarizes the initial and ongoing annual burden estimates.

**Table 5: Rule 211(h)(2)-3 PRA Estimates**

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
ESTIMATES					

<sup>1846</sup> See AIC Comment Letter I.

<sup>1847</sup> See CCMR Comment Letter I.

<sup>1848</sup> See MFA Comment Letter I. We note, however, that the final rule contains a legacy provision.

Preparation of written notice <sup>6</sup>	12 hours	8 hours <sup>2</sup>	\$435 (blended rate for compliance attorney (\$425), accounting manager (\$337), and assistant general counsel (\$543))	\$3,480	\$565 <sup>3</sup>
Provision/distribution of written notice <sup>6</sup>	1 hours	3.33 hours <sup>4</sup>	\$73 (rate for general clerk)	\$243.09	
Total new annual burden per private fund		11.33 hours		\$3,723.09	\$565
Avg. number of private funds per adviser		8 private funds		8 private funds	8 private funds
Number of advisers		12,234 advisers		12,234 advisers	9,176 advisers <sup>5</sup>
Total new annual burden		1,108,890 hours		\$364,386,264.48	\$41,475,520

Notes:

1. See SIFMA data sets, *supra* Note 1 to Table 1 Rule 211(h)(1)-2 PRA Estimates.

2. This includes the internal initial burden estimate annualized over a three-year period, plus 4 hours of ongoing annual burden hours and assumes notices will be issued once annually to existing investors and once quarterly for prospective investors. The estimate of 8 hours is based on the following calculation: ((12 initial hours / 3 years) + 4 hours of additional ongoing burden hours) = 8 hours. The burden hours associated with reviewing preferential treatment provided to other investors in the same fund and updating the written notice take into account that (i) most closed-end funds will only raise new capital for a finite period of time and thus the burden hours will likely decrease after the fundraising period terminates for such funds since they will not continue to seek new investors and will not continue to agree to new preferential treatment for new investors and (ii) most open-end private funds continuously raise capital and thus the burden hours will likely remain the same year over year since they will continue to seek new investors and will continue to agree to preferential treatment for new investors.

3. This estimated burden is based on the estimated wage rate of \$565/hour, for 1 hours, for outside legal services at the same frequency as the internal burden hours estimate. The Commission's estimates of the relevant wage rates for external time costs, such as outside legal services, take into account staff experience, a variety of sources including general information websites, and adjustments for inflation.

4. This includes the internal initial burden estimate annualized over a three-year period, plus 3 hours of ongoing annual burden hours. The estimate of 3.33 hours is based on the following calculation: ((1 initial hours / 3 years) + 3 hours of additional ongoing burden hours) = 3.33 hours.

5. We estimate that 75% of advisers will use outside legal services for these collections of information. This estimate takes into account that advisers may elect to use outside legal services (along with in-house counsel), based on factors such as adviser budget and the adviser's standard practices for using outside legal services, as well as personnel availability and expertise.

6. References to written notices in this table, and the burdens associated with the preparation, provision, and distribution thereof, include estimates related to advisers (i) offering the same preferential redemption terms to all existing and future investors and (ii) offering the same preferential information to all other investors, in each case, in accordance with the exceptions to the prohibitions aspect of the final rule.

#### **G. Written Documentation of Adviser's Annual Review of Compliance Program**

The amendment to rule 206(4)-7 requires investment advisers that are registered or required to be registered to document the annual review of their compliance policies and procedures in writing.<sup>1849</sup> We believe that such a requirement will focus renewed attention on the importance of the annual compliance review process and will help ensure that advisers maintain records regarding their annual compliance review that will allow our staff to determine whether an adviser has complied with the compliance rule.

This collection of information is found at 17 CFR 275.206(4)-7 and is mandatory. The Commission staff uses the collection of information in its examination and oversight program. As noted above, responses provided to the Commission in the context of its examination and oversight program concerning the amendments to rule 206(4)-7 will be kept confidential subject to the provisions of applicable law.

Based on IARD data, as of December 31, 2022, there were 15,361 investment advisers registered with the Commission. In our most recent PRA submission for rule 206(4)-7, we estimated a total hour burden of 1,293,840 hours and a total monetized time burden of \$322,036,776. As noted above, all advisers that are registered or required to be registered, including advisers to SAFs, will be required to document their annual review in writing.

Commenters argued there would be certain additional costs associated with the amendment to rule 206(4)-7, such as compliance consultants or outside counsel.<sup>1850</sup> We have adjusted this estimate upwards from the proposal to reflect the final amendments, updated data, and comments we received to our estimates asserting that we underestimated these figures in the

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<sup>1849</sup> See rule 206(4)-7(b).

<sup>1850</sup> Curtis Comment Letter; SBAI Comment Letter.

proposal. The table below summarizes the initial and ongoing annual burden estimates associated with the amendments to rule 206(4)-7.

**Table 6: Rule 206(4)-7 PRA Estimates**

	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
<b>ESTIMATES</b>				
Written documentation of annual review	5.5 hours <sup>2</sup>	\$484 (blended rate for compliance attorney (\$425) and assistant general counsel (\$543))	\$2,662	\$459 <sup>3</sup>
Number of advisers	15,361 advisers		15,361 advisers	7,681 advisers <sup>4</sup>
Total new annual burden	84,486 hours		\$40,890,982	\$3,525,579

Notes:

1. See SIFMA data sets, *supra* Note 1 to Table 1 Rule 211(h)(1)-2 PRA Estimates.

2. We estimate that these amendments will increase each registered investment adviser's average annual collection burden under rule 206(4)-7 by 5.5 hours.

3. This estimated burden is based on the sum of the estimated wage rate of \$565/hour, for 0.5 hours, (\$282.5) for outside legal services and the estimated wage rate of \$353/hour, for 0.5 hours, (\$176.5) for outside accountant assistance.

4. We estimate that 50% of advisers will use outside legal services for these collections of information. This estimate takes into account that advisers may elect to use outside legal services (along with in-house counsel), based on factors such as adviser budget and the adviser's standard practices for using outside legal services, as well as personnel availability and expertise.

## **H. Recordkeeping**

The amendments to rule 204-2 will require advisers to private funds, where the adviser is registered or required to be registered with the Commission, to retain books and records related to the quarterly statement rule, the audit rule, the adviser-led secondaries rule, the restricted

activities rules, and the preferential treatment rule.<sup>1851</sup> These amendments will help facilitate the Commission's inspection and enforcement capabilities.

Specifically, the books and records amendments related to the quarterly statement rule will require advisers to (i) retain a copy of any quarterly statement distributed to fund investors as well as a record of each addressee and the date(s) the statement was sent; (ii) retain all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any statement delivered pursuant to the quarterly statement rule; and (iii) make and keep documentation substantiating the adviser's determination that the private fund it manages is a liquid fund or an illiquid fund pursuant to the quarterly statement rule.<sup>1852</sup>

The books and records amendments related to the audit rule will require advisers to keep a copy of any audited financial statements distributed along with a record of each addressee and the corresponding date(s) sent.<sup>1853</sup> Additionally, the rule will require the adviser to keep a record documenting steps it took to cause a private fund client with which it is not in a control relationship to undergo a financial statement audit that will comply with the rule.<sup>1854</sup>

The books and records amendments related to the adviser-led secondaries rule will require advisers to retain a copy of any fairness or valuation opinion and summary of material business relationships distributed pursuant to the rule along with a record of each addressee and the corresponding date(s) sent.<sup>1855</sup>

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<sup>1851</sup> See final amended rule 204-2.

<sup>1852</sup> See final amended rule 204-2(a)(20)(i) and (ii), and (a)(22).

<sup>1853</sup> See final amended rule 204-2(a)(21)(i).

<sup>1854</sup> See final amended rule 204-2(a)(21)(ii).

<sup>1855</sup> See final amended rule 204-2(a)(23).



The books and records amendments related to the preferential treatment rule will require advisers to retain copies of all written notices sent to current and prospective investors in a private fund pursuant to final rule 211(h)(2)-3.<sup>1856</sup> In addition, advisers will be required to retain copies of a record of each addressee and the corresponding date(s) sent.<sup>1857</sup>

The books and records amendments related to the restricted activities rule will require advisers to retain copies of all notifications, consent forms, or other documents distributed to (and received from) private fund investors pursuant to the restricted activities rule, along with a record of each addressee and the corresponding date(s) sent.

The respondents to these collections of information requirements will be investment advisers that are registered or required to be registered with the Commission that advise one or more private funds. Based on IARD data, as of December 31, 2022, there were 15,361 investment advisers registered with the Commission. According to this data, 5,248 registered advisers provide advice to private funds.<sup>1858</sup> We estimate that these advisers, on average, each provide advice to 10 private funds.<sup>1859</sup> We further estimate that these private funds, on average, each have a total of 80 investors.<sup>1860</sup> As a result, an average private fund adviser has, on average, a total of 800 investors across all private funds it advises.

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<sup>1856</sup> See final amended rule 204-2(a)(7)(v).

<sup>1857</sup> *Id.*

<sup>1858</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1). The final quarterly statement, audit, adviser-led secondaries, restricted activities, and preferential treatment rules will not apply to SAF advisers with respect to SAFs they advise. These figures do not include SAF advisers that manage only SAFs.

<sup>1859</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1). The final quarterly statement, audit, adviser-led secondaries, restricted activities, and preferential treatment rules will not apply to SAFs. These figures do not include SAFs.

<sup>1860</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).A., #13.

In our most recent PRA submission for rule 204-2,<sup>1861</sup> we estimated for rule 204-2 a total hour burden of 2,803,536 hours, and the total annual internal cost burden is \$179,000,834.<sup>1862</sup> This collection of information is found at 17 CFR 275.204-2 and is mandatory. The Commission staff uses the collection of information in its examination and oversight program. As noted above, responses provided to the Commission in the context of its examination and oversight program concerning the amendments to rule 204-2 will be kept confidential subject to the provisions of applicable law.

Several commenters stated that the recordkeeping requirements would be burdensome.<sup>1863</sup> We have adjusted the estimates upwards from the proposal to reflect the final amendments, updated data, and comments we received to our estimates asserting that we underestimated these figures in the proposal. We are also revising the estimates upwards to reflect the additional recordkeeping obligations we are adopting, such as the requirement to maintain records related to the restricted activities rule. We have adjusted these estimates to reflect that the final quarterly statement, audit, adviser-led secondaries, restricted activities, and preferential treatment rules will not apply to SAF advisers with respect to SAFs they advise as well.

The table below summarizes the initial and ongoing annual burden estimates associated with the amendments to rule 204-2.

**Table 7: Rule 204-2 PRA Estimates**

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<sup>1861</sup> Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Revisions to Rule 204-2, OMB Report, OMB 3235-0278 (May 2023).

<sup>1862</sup> Under the currently approved PRA for Rule 204-2, there is no cost burden other than the internal cost of the hour burden, and we believe that the amendments will not result in any external cost burden.

<sup>1863</sup> *See, e.g.*, AIMA/ACC Comment Letter; ATR Comment Letter.

	Internal annual burden hours <sup>1</sup>	Wage rate <sup>2</sup>	Internal time cost	Annual external cost burden
ESTIMATES				
Retention of quarterly statement and calculation information; making and keeping records re liquid/illiquid fund determination	0.50 hours	\$77.5 (blended rate for general clerk (\$73) and compliance clerk (\$82))	\$38.75	\$0
Avg. number of private funds per adviser	10 private funds		10 private funds	\$0
Number of advisers	5,248 advisers		5,248 advisers	\$0
Sub-total burden	26,240 hours		\$2,033,600	\$0
Retention of written notices re preferential treatment	1 hours	\$77.5 (blended rate for general clerk (\$73) and compliance clerk (\$82))	\$77.5	\$0
Avg. number of private funds per adviser	10 private funds <sup>3</sup>		10 private funds <sup>3</sup>	\$0
Number of advisers	5,248 advisers		5,248 advisers	\$0
Sub-total burden	52,480 hours		\$4,067,200	\$0
Retention and distribution of audited financial statements; making and keeping records re: steps to cause a private fund client that the adviser does not control to undergo a	0.50 hours	\$77.5 (blended rate for general clerk (\$73) and compliance clerk (\$82))	\$38.75	\$0

financial statement audit				
Avg. number of private funds per adviser	10 private funds		10 private funds	\$0
Number of advisers	5,248 advisers		5,248 advisers	\$0
Sub-total burden	26,240 hours		\$2,033,600	\$0
Retention and distribution of fairness/valuation opinion and summary of material business relationships	1.5 hour	\$77.5 (blended rate for general clerk (\$73) and compliance clerk (\$82))	\$116.25	\$0
Avg. number of private funds per adviser that conduct an adviser-led transaction	1 private fund		1 private fund	\$0
Number of advisers	525 advisers <sup>4</sup>		525 advisers <sup>4</sup>	\$0
Sub-total burden	787.5 hours		\$61,031.25	\$0
Retention of written notices, consent forms, and other documents for restricted activities	3.5 hours	\$77.5 (blended rate for general clerk (\$73) and compliance clerk (\$82))	\$271.25	\$0
Avg. number of private funds per adviser	10 private funds <sup>3</sup>		10 private funds <sup>3</sup>	\$0
Number of advisers	5,248 advisers		5,248 advisers	\$0
Sub-total burden	183,680 hours		\$14,235,200	
<b>Total burden</b>	<b>289,427.5 hours</b>		<b>\$22,430,631.25</b>	<b>\$0</b>

Notes:

1. Hour burden and cost estimates for these rule amendments assume the frequency of each collection of information for the substantive rule with which they are associated. For example, the hour burden estimate for recordkeeping obligations associated with the amendments to rule 204-2(a)(20) and (22) will assume the same frequency of collection of information as under final rule 211(h)(1)-2.

2. See SIFMA data sets, *supra* Note 1 to Table 1 Rule 211(h)(1)-2 PRA Estimates.

3. Final rules 211(h)(2)-1 and 211(h)(2)-3 apply to all private fund advisers, but the amendments to rule 204-2 only apply to advisers that are registered or required to be registered with the Commission. As discussed above, we estimate that advisers that are registered or required to be registered with the Commission each advise 10 private funds on average.

4. See *supra* section VII.E (Adviser-Led Secondaries).

## **I. Request for Comment Regarding Rule 211(h)(2)-1**

We request comment on whether the estimates associated with the new collection of information requirements in “Rule 211(h)(2)-1 under the Advisers Act” are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (1) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (2) evaluate the accuracy of the Commission’s estimate of the burden of the proposed collection of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) determine whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the OMB Desk Officer for the Securities and Exchange Commission, MBX.OMB.OIRA.SEC\_desk\_officer@omb.eop.gov, and should send a copy to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File No. S7-03-22. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File

No. S7-03-22, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington, DC 20549-2736.

## **VIII. FINAL REGULATORY FLEXIBILITY ANALYSIS**

The Commission has prepared the following Final Regulatory Flexibility Analysis (“FRFA”) in accordance with section 4(a) of the RFA.<sup>1864</sup> It relates to the following rules and rule amendments under the Advisers Act: (i) rule 211(h)(1)-1; (ii) rule 211(h)(1)-2; (iii) rule 206(4)-10; (iv) rule 211(h)(2)-1; (v) rule 211(h)(2)-2; (vi) rule 211(h)(2)-3; (vii) amendments to rule 204-2; and (viii) amendments to rule 206(4)-7.

### **A. Reasons for and Objectives of the Final Rules and Rule Amendments**

#### **1. Final rule 211(h)(1)-1**

We are adopting final rule 211(h)(1)-1 under the Advisers Act (“definitions rule”), which contains numerous definitions for purposes of final rules 211(h)(1)-2, 206(4)-10, 211(h)(2)-1, 211(h)(2)-2, and 211(h)(2)-3 and the final amendments to rule 204-2.<sup>1865</sup> We chose to include these definitions in a single rule for ease of reference, consistency, and brevity.

#### **2. Final rule 211(h)(1)-2**

We are adopting final rule 211(h)(1)-2 under the Advisers Act, which requires any investment adviser registered or required to be registered with the Commission that provides investment advice to a private fund (other than a SAF) that has at least two full fiscal quarters of operating results to prepare and distribute a quarterly statement to private fund investors that includes certain standardized disclosures regarding the costs of investing in the private fund and

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<sup>1864</sup> 5 U.S.C. 603(a).

<sup>1865</sup> See final rule 211(h)(1)-1.

the private fund's performance.<sup>1866</sup> We believe that providing this information to private fund investors in a simple and clear format is appropriate and in the public interest and will improve investor protection and make investors better informed. The reasons for, and objectives of, final rule 211(h)(1)-2 are discussed in more detail in sections I and II above. The burdens of this requirement on small advisers are discussed below as well as above in sections VI and VII, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VII.

### **3. Final rule 206(4)-10**

We are adopting final rule 206(4)-10 under the Advisers Act, which will generally require all investment advisers that are registered or required to be registered with the Commission to have their private fund clients (other than a SAF client) undergo a financial statement audit that meets the requirements of the audit provision of the custody rule (*i.e.*, rule 206(4)-2(b)(4)), which are incorporated into the new rule by reference, as described above in section II. The final rule is designed to provide protection for the fund and its investors against the misappropriation of fund assets and to provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees, and to align with the audit requirements in the audit provision of the custody rule. The reasons for, and objectives of, the final audit rule are discussed in more detail in sections I and II, above. The burdens of these requirements on small advisers are discussed below as well as above in sections VI and VII, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VII.

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<sup>1866</sup> See final rule 211(h)(1)-2.

#### 4. Final rule 211(h)(2)-1

Final rule 211(h)(2)-1 will restrict all private fund advisers (other than an adviser to SAFs with respect to such funds) from, directly or indirectly, engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors. Specifically, the rule prohibits an adviser from engaging in the following activities, unless it provides written disclosure to investors and, in some cases, obtain investor consent : (1) charging certain fees and expenses to a private fund (including fees or expenses associated with an investigation of the adviser or its related persons by governmental or regulatory authorities, regulatory, examination, or compliance expenses or fees of the adviser or its related persons,<sup>1867</sup> or fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment); (2) reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders; and (3) borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client.<sup>1868</sup> Each of these restrictions is described in more detail above in section II. As discussed above, we believe that these sales practices, conflicts of interest, and compensation schemes must be restricted, and the final rule will prohibit these activities, unless the adviser provides specified disclosures to investors and, in some cases, obtain investor consent under the final rule. Also, the final rule restricts these activities even if

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<sup>1867</sup> However, the final rule prohibits advisers from charging for 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 Act or the rules promulgated thereunder.

<sup>1868</sup> See final rule 211(h)(2)-1(a).



they are performed indirectly, for example by an adviser's related persons, because the activities have an equal potential to harm investors regardless of whether the adviser engages in the activity directly or indirectly. The reasons for, and objectives of, the final rule are discussed in more detail in sections I and II, above. The burdens of these requirements on small advisers are discussed below as well as above in sections VI and VII, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VII.

## **5. Final rule 211(h)(2)-2**

We are adopting final rule 211(h)(2)-2 under the Advisers Act, which generally requires an adviser that is registered or required to be registered with the Commission and is conducting an adviser-led secondary transaction with respect to any private fund that it advises (other than a SAF), where the adviser (or its related persons) offers fund investors the option between selling their interests in the private fund, and converting or exchanging them for new interests in another vehicle advised by the adviser or its related persons, to, prior to the due date of an investor participation election form in respect of the transaction, obtain and distribute to investors in the private fund a fairness opinion or valuation opinion from an independent opinion provider and a summary of any material business relationships that the adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance date of the fairness opinion or valuation opinion, with the independent opinion provider. The specific requirements of the final rule are described above in section II. The final rule is designed to provide an important check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors. The reasons for, and objectives of, the final rule are discussed in more detail in sections I and II above. The burdens

of these requirements on small advisers are discussed below as well as above in sections VI and VII, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VII.

## **6. Final rule 211(h)(2)-3**

Final rule 211(h)(2)-3 will prohibit a private fund adviser (other than an adviser to SAFs with respect to such funds), directly or indirectly, from: (1) granting an investor in a private fund or in a similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets, with an exception for redemptions that are required by applicable law, rule, regulation, or order of certain governmental authorities and another if the adviser offers the same redemption ability to all existing and future investors in the private fund or similar pool of assets; or (2) providing information regarding the portfolio holdings or exposures of the private fund, or of a similar pool of assets, to any investor in the private fund if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a similar pool of assets, with an exception where the adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time.<sup>1869</sup> The final rule will also prohibit these advisers from providing any other preferential treatment to any investor in a private fund unless the adviser provides written disclosures to prospective investors of the private fund regarding preferential treatment related to any material economic terms, as well as written disclosures to current investors in the private fund regarding all preferential treatment, which the adviser or its related

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<sup>1869</sup> See final rule 211(h)(2)-3.

persons has provided to other investors in the same fund.<sup>1870</sup> These requirements are described above in section II. The final rule is designed to restrict sales practices that present a conflict of interest between the adviser and the private fund client that are contrary to the public interest and protection of investors and certain practices that can be fraudulent and deceptive. The disclosure elements of the final rule are designed to also help investors shape the terms of their relationship with the adviser of the private fund. The reasons for, and objectives of, the final rule are discussed in more detail in sections I and II, above. The burdens of these requirements on small advisers are discussed below as well as above in sections VI and VII, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VII.

## **7. Final amendments to rule 204-2**

We are also adopting related amendments to rule 204-2, the books and records rule, which sets forth various recordkeeping requirements for registered investment advisers. We are amending the current rule to require investment advisers to private funds to make and keep records relating to the quarterly statements required under final rule 211(h)(1)-2, the financial statement audits performed under final rule 206(4)-10, disclosures regarding restricted activities provided under final rule 211(h)(2)-1, fairness opinions or valuation opinions required under final rule 211(h)(2)-2, and disclosure of preferential treatment required under final rule 211(h)(2)-3. The reasons for, and objectives of, the final amendments to the books and records rule are discussed in more detail in sections I and II above. The burdens of these requirements on small advisers are discussed below as well as above in sections VI and VII, which discuss the

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<sup>1870</sup> See final rule 211(h)(2)-3(b).

burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VII.

## **8. Final amendments to rule 206(4)-7**

We are adopting amendments to rule 206(4)-7 to require all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing, as described above in section III. The final amendments are designed to focus renewed attention on the importance of the annual compliance review process and will better enable our staff to determine whether an adviser has complied with the review requirement of the compliance rule. The reasons for, and objectives of, the final amendments are discussed in more detail in sections I and III, above. The burdens of these requirements on small advisers are discussed below as well as above in sections VI and VII, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VII.

### **B. Significant Issues Raised by Public Comments**

One commenter provided its own calculations of the number of small entities impacted by the rules using both the Commission's definition of small entity and a different definition, and the commenter's reasoning for using a different definition is premised on the commenter's belief that the Commission is required to conduct a regulatory impact analysis.<sup>1871</sup> However, as discussed above, the Commission was not required to perform a regulatory impact analysis.<sup>1872</sup> Under Commission rules, for the purposes of the Advisers Act and the RFA, an investment adviser generally is a small entity if it meets the definition set forth in Advisers Act rule 0-7(a).

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<sup>1871</sup> See LSTA Comment Letter, Exhibit C.

<sup>1872</sup> See *supra* section VI.B.

Additionally, in providing its own calculations, this commenter calculated the number of private funds that would be “small entities” according to its own definition,<sup>1873</sup> as well as the definition set forth in Advisers Act rule 0-7(a), which sets forth the criteria for determining whether an investment adviser (*and not a private fund*) is a “small entity” for purposes of the RFA analysis. As a result, this commenter assumed that the “small entities” directly subject to the rules would be private funds, rather than investment advisers to private funds. The Commission’s analysis, however, correctly analyzed the impact on investment advisers.

More generally, as discussed above, many commenters expressed broader concerns that there may be negative effects on competition, including through effects on smaller, emerging advisers.<sup>1874</sup> For example, commenters stated that restrictions on preferential treatment may hinder smaller advisers’ abilities to secure initial seed or anchor investors, stating that smaller, emerging advisers often need to provide anchor investors significant preferential rights.<sup>1875</sup> Commenters also stated more generally that increased compliance costs on advisers may reduce competition by causing advisers, particularly smaller advisers, to close their funds and reducing the choices investors have among competing advisers and funds.<sup>1876</sup> In particular, some commenters stated that the combined costs of multiple ongoing rulemakings would harm investors by making it cost-prohibitive for many advisers to stay in business or for new advisers to start a business, and that this effect would further harm competition by creating new barriers

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<sup>1873</sup> This commenter stated that, according to a benchmark from the Small Business Administration, “investment vehicles” with assets of under \$35 million would constitute a “small business.” *See* LSTA Comment Letter, Exhibit C.

<sup>1874</sup> *See supra* section VI.E.2.

<sup>1875</sup> *Id.*

<sup>1876</sup> *Id.*

to entry.<sup>1877</sup> Commenters lastly stated that the loss of smaller advisers would result in reduced diversity of investment advisers, based on an assertion that most women- and minority-owned advisers are smaller and more frequently associated with first time funds, and that reduced diversity of investment advisers may also have downstream effects on entrepreneurial diversity.<sup>1878</sup>

The Commission's analysis more generally considered potential impact on small entities, meaning small advisers, and identified several factors that may mitigate potential negative effects.<sup>1879</sup> First, the potential harms to smaller advisers from the preferential treatment rule will be mitigated to the extent that smaller, emerging advisers do not need to be able to offer anchor investors preferential rights that have a material negative effect on other investors in order to effectively compete, and to the extent that smaller emerging advisers are able to compete effectively by offering anchor investors other types of preferential terms.<sup>1880</sup> Second, the compliance cost effects on the smallest advisers will be mitigated where those advisers do not meet the minimum assets under management required to register with the SEC.<sup>1881</sup> Third, the literature on the downstream effects of diversity in investment advisory services indicates that the effects are strongest for venture capital, and so the effect may be mitigated wherever an adviser's funds are sufficiently concentrated in venture capital that they may forgo SEC

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<sup>1877</sup> *Id.*

<sup>1878</sup> *Id.*

<sup>1879</sup> Certain other commenters expressed broader concerns that there may be negative effects on competition, including through effects on smaller, emerging advisers. *See supra* section VI.E.2.

<sup>1880</sup> *Id.*

<sup>1881</sup> Some registered advisers may therefore have the option of reducing their assets under management in order to forgo registration, thereby avoiding the costs of the final rules that only apply to registered advisers, such as the mandatory audit rule. *Id.*

registration and thus forgo many of the costs of the final rules.<sup>1882</sup> Lastly, with respect to commenter concerns on the combined costs of multiple rulemakings, each adopting release considers an updated economic baseline that incorporates any new regulatory requirements, including compliance costs, at the time of each adoption, and considers the incremental new benefits and incremental new costs over those already resulting from the preceding rules.<sup>1883</sup> With respect to competitive effects, the Commission acknowledges that there are incremental effects of new compliance costs on advisers that may vary depending on the total amount of compliance costs already facing advisers and acknowledges costs from overlapping transition periods for recently adopted rules and the final private fund adviser rules.<sup>1884</sup>

We have also taken several steps to lessen the possible burden on smaller advisers. First, for significant portions of the rules, we have allowed a longer transition period, *i.e.*, up to 18 months, for smaller private fund advisers.<sup>1885</sup> Second, we have provided certain legacy status provisions, namely regarding contractual agreements that govern a private fund and that were entered into prior to the compliance date if the rule would require the parties to amend such an agreement, for all advisers under the prohibitions aspect of the preferential treatment rule and certain aspects of the restricted activities rule.<sup>1886</sup> Third, for the restricted activities rule, we adopted certain disclosure-based exceptions rather than outright prohibitions.<sup>1887</sup> Fourth, we

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<sup>1882</sup> *Id.*

<sup>1883</sup> *See supra* sections VI.D, VI.E.2.

<sup>1884</sup> *Id.*

<sup>1885</sup> *See supra* section IV (allowing up to 18 months for smaller private fund advisers to comply with the quarterly statement rule, the mandatory private fund adviser audit rule, the adviser-led secondaries rule, and the restricted activities rule).

<sup>1886</sup> *See supra* section IV (allowing legacy status under limited circumstances to prevent advisers and investors from having to renegotiate existing fund documents).

<sup>1887</sup> *See supra* section II.E (discussing disclosure-based exceptions and, in some cases, consent-based exceptions for certain fees and expenses, post-tax clawbacks, non-pro rata allocations, and borrowing).

have extended the adviser-led secondaries rule to allow for valuation opinions in addition to fairness opinions.<sup>1888</sup> Fifth, for the preferential activities prohibitions, we adopted certain exceptions to the prohibition on the provision of certain preferential redemption terms, such as when those terms are offered to all investors.<sup>1889</sup> To the extent the effects identified by commenters still occur with these changes to the final rules, smaller advisers may be impacted, but these potential negative effects on smaller advisers must be evaluated in light of (1) the other pro-competitive aspects of the final rules, in particular the pro-competitive effects from enhancing transparency, which are likely to help smaller advisers effectively compete, and (2) the other benefits of the final rules.<sup>1890</sup>

### **C. Legal Basis**

The Commission is adopting final rules 211(h)(1)-1, 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, 211(h)(2)-3, and 206(4)-10 under the Advisers Act under the authority set forth in sections 203(d), 206(4), 211(a), and 211(h) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(d), 80b-6(4) and 80b-11(a) and (h)). The Commission is adopting amendments to rule 204-2 under the Advisers Act under the authority set forth in sections 204 and 211 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-4 and 80b-11). The Commission is adopting amendments to rule 206(4)-7 under the Advisers Act under the authority set forth in sections 203(d), 206(4), and 211(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(d), 80b-6(4), and 80b-11(a)).

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<sup>1888</sup> See *supra* section II.D.2.

<sup>1889</sup> See *supra* section II.G.

<sup>1890</sup> See *supra* section VI.E.2.



#### **D. Small Entities Subject to Rules**

In developing these rules and amendments, we have considered their potential impact on small entities. Some of the rules and amendments will affect many, but not all, investment advisers registered with the Commission, including some small entities. The amendments to rule 206(4)-7 will affect all investment advisers that are registered or required to be registered with the Commission, including some small entities, and final rules 211(h)(2)-1 and 211(h)(2)-3 will apply to all advisers to private funds (even if not registered), including some small entities. Final rule 211(h)(1)-1 will affect all advisers that are also affected by one of the rules applying to private fund advisers discussed below, including all that are small entities, regardless of whether they are registered. Under Commission rules, for the purposes of the Advisers Act and the RFA, an investment adviser generally is a small entity if it: (1) has assets under management having a total value of less than \$25 million; (2) did not have total assets of \$5 million or more on the last day of the most recent fiscal year; and (3) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had total assets of \$5 million or more on the last day of its most recent fiscal year.<sup>1891</sup>

Other than the definitions rule, restrictions rule, and preferential treatment rule, our rules and amendments will not affect most investment advisers that are small entities (“small advisers”) because those rules apply only to registered advisers, and small registered advisers are generally registered with one or more State securities authorities and not with the Commission. Under section 203A of the Advisers Act, most small advisers are prohibited from registering with the Commission and are regulated by State regulators. Based on IARD data, we estimate

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<sup>1891</sup> 17 CFR 275.0-7(a) (Advisers Act rule 0-7(a)).

that as of December 31, 2022, approximately 489 SEC-registered advisers are small entities under the RFA.<sup>1892</sup> All of these advisers will be affected by the amendments to the compliance rule, and we estimate that approximately 26 small advisers to one or more private funds will be affected by the quarterly statement rule, audit rule, and secondaries rule.<sup>1893</sup>

The restricted activities rule and the preferential treatment rule, however, will have an impact on *all* investment advisers to private funds, regardless of whether they are registered with the Commission, one or more State securities authorities, or are unregistered. It is difficult for us to estimate the number of advisers not registered with us that have private fund clients.

However, we are able to provide the following estimates based on IARD data. As of December 31, 2022, there are 5,368 ERAs, all of whom advise private funds, by definition.<sup>1894</sup> All ERAs will, therefore, be subject to the rules that will apply to all private fund advisers. We estimate that there are no ERAs that would meet the definition of “small entity.”<sup>1895</sup> We do not have a method for estimating the number of State-registered advisers to private funds that would meet the definition of “small entity.”

Additionally, the restricted activities rule and the preferential treatment rule will apply to other advisers that are not registered with the SEC or with the States and that do not make filings with either the SEC or States. This includes foreign private advisers,<sup>1896</sup> advisers that are entirely unregistered, and advisers that rely on the intrastate exemption from SEC registration

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<sup>1892</sup> Based on SEC-registered investment adviser responses to Items 5.F. and 12 of Form ADV.

<sup>1893</sup> The final quarterly statement, audit, and adviser-led secondaries rules will not apply to SAF advisers with respect to SAFs they advise. This figure does not include SAF advisers that manage only SAFs.

<sup>1894</sup> See section 203(l) of the Advisers Act and rule 203(m)-1.

<sup>1895</sup> In order for an adviser to be an SEC ERA it would first need to have an SEC registration obligation, and an adviser with that little in assets under management (*i.e.*, assets under management that is low enough to allow the adviser to qualify as a small entity) would not have an SEC registration obligation.

<sup>1896</sup> See section 202(a)(30) of the Advisers Act (defining “foreign private adviser”).

and/or the *de minimis* exemption from SEC registration. We are unable to estimate the number of advisers in each of these categories because these advisers do not file reports or other information with the SEC and we are unable to find reliable, public information. As a result, our estimates are based on information from SEC-registered advisers to private funds, exempt reporting advisers (at the State and Federal levels), and State-registered advisers to private funds.

The definitions rule will affect all advisers that are also affected by one of the rules applying to private fund advisers discussed above. It has no independent substantive requirements or economic impacts. Therefore, the number of small advisers affected by this rule is accounted for in those discussions and not separately and additionally delineated.

## **E. Projected Reporting, Recordkeeping, and other Compliance Requirements**

### **1. Final rule 211(h)(1)-1**

Final rule 211(h)(1)-1 will not impose any reporting, recordkeeping, or other compliance requirements on investment advisers because it has no independent substantive requirements or economic impacts. The rule will not affect an adviser unless it was complying with final rules 211(h)(1)-2, 206(4)-10, 211(h)(2)-1, 211(h)(2)-2, or 211(h)(2)-3, each of which is discussed below.

### **2. Final rule 211(h)(1)-2**

Final rule 211(h)(1)-2 will impose certain compliance requirements on investment advisers, including those that are small entities. It will require any investment adviser registered or required to be registered with the Commission that provides investment advice to a private fund (other than a SAF) that has at least two full fiscal quarters of operating results to prepare and distribute quarterly statements with certain fee and expense and performance disclosure to private fund investors. The final requirements, including compliance and related recordkeeping

requirements that will be required under the final amendments to rule 204-2 and rule 206(4)-7, are summarized in this FRFA (section VIII.A. above). All of these final requirements are also discussed in detail, above, in sections I and II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections VI and VII (the Economic Analysis and Paperwork Reduction Act analysis, respectively) and below. The professional skills required to meet these specific burdens are also discussed in section VII.

As discussed above, there are approximately 26 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers will be subject to the final rule 211(h)(1)-2. As discussed in our Paperwork Reduction Act Analysis in section VII above, we estimate that the final rule 211(h)(1)-2 under the Advisers Act, which will require advisers to prepare and distribute quarterly statements, will create a new annual burden of approximately 190 hours per adviser, or 4,940 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with the final rule to be \$2,416,310.<sup>1897</sup>

### **3. Final rule 206(4)-10**

Final rule 206(4)-10 will impose certain compliance requirements on investment advisers, including those that are small entities. All SEC-registered investment advisers that provide investment advice, including small entity advisers, to private fund clients (other than a SAF) will be required to comply with the final rule's requirements to have their private fund clients undergo a financial statement audit (at least annually and upon liquidation) and distribute audited financial statements to private fund investors, in alignment with the requirements of the

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<sup>1897</sup> This includes the internal time cost and the annual external cost burden and assumes that, for purposes of the annual external cost burden, 50% of small advisers will use outside legal services, as set forth in the PRA estimates table.

audit provision of the custody rule (which the final rule will incorporate by reference). The final requirements, including compliance and related recordkeeping requirements that will be imposed under the final amendments to rule 204-2 and rule 206(4)-7, are summarized in this FRFA (section VIII.A. above). All of these final requirements are also discussed in detail, above, in sections I and II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections VI and VII (the Economic Analysis and Paperwork Reduction Act analysis, respectively) and below. The professional skills required to meet these specific burdens are also discussed in section VII.

As discussed above, there are approximately 26 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers will be subject to the final rule 206(4)-10. As discussed above in our Paperwork Reduction Act Analysis in section VII above, we estimate that final rule 206(4)-10 under the Advisers Act will create a new annual burden of approximately 13.30 hours per adviser, or 345.80 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with the final rule to be \$19,560,515.<sup>1898</sup>

#### **4. Final rule 211(h)(2)-1**

Final rule 211(h)(2)-1 will impose certain compliance requirements on investment advisers, including those that are small entities. Final rule 211(h)(2)-1 will restrict all private fund advisers (other than an adviser to SAFs with respect to such funds) from engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors. Specifically, the rule prohibits advisers from engaging in

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<sup>1898</sup> This includes the internal time cost and the annual external cost burden, as set forth in the PRA estimates table.

the following activities, unless they provide written disclosure to investors regarding such activities and in some cases obtain investor consent: (1) charging certain fees and expenses to a private fund (including fees or expenses associated with an investigation of the adviser or its related persons by governmental or regulatory authorities, regulatory, examination, or compliance expenses or fees of the adviser or its related persons, or fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment); (2) reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders; and (3) borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit from a private fund client. The requirements, including compliance and related recordkeeping requirements that will be imposed under the final amendments to rule 204-2 and rule 206(4)-7, are summarized in this FRFA (section VIII.A. above). All of these final requirements are also discussed in detail, above, in sections I and II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections VI and VII (the Economic Analysis and Paperwork Reduction Act analysis, respectively) and below. The professional skills required to meet these specific burdens are also discussed in section VII.

As discussed above, there are approximately 26 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers will be subject to the final rule 211(h)(2)-1. As discussed above, we estimate that there are no ERAs that meet the definition of “small entity” and we do not have a method for estimating the number of State-

registered advisers to private funds that meet the definition of “small entity.”<sup>1899</sup> As discussed above in our Paperwork Reduction Act Analysis in section VII above, rule 211(h)(2)-1 under the Advisers Act is estimated to create a new annual burden of approximately 120 hours per adviser, or 3,120 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with the rule to be \$1,589,280.<sup>1900</sup>

## **5. Final rule 211(h)(2)-2**

Final rule 211(h)(2)-2 will impose certain compliance requirements on investment advisers, including those that are small entities. The rule generally requires an adviser that is registered or required to be registered with the Commission and is conducting an adviser-led secondary transaction with respect to any private fund that it advises (other than a SAF), where the adviser (or its related persons) offers fund investors the option between selling their interests in the private fund, or converting or exchanging them for new interests in another vehicle advised by the adviser or its related persons, to, prior to the due date of an investor participation election form in respect of the transaction, obtain and distribute to investors in the private fund a fairness opinion or valuation opinion from an independent opinion provider and a summary of any material business relationships that the adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance date of the fairness opinion or valuation opinion, with the independent opinion provider. The final requirements, including compliance and related recordkeeping requirements that will be imposed under final amendments to rule 204-2 and 206(4)-7, are summarized in this FRFA (section VIII.A. above).

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<sup>1899</sup> See *supra* section VIII.D.

<sup>1900</sup> This includes the internal time cost and the annual external cost burden and assumes that, for purposes of the annual external cost burden, 75% of small advisers will use outside legal services, as set forth in the PRA table.

All of these final requirements are also discussed in detail, above, in sections I and II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections VI and VII (the Economic Analysis and Paperwork Reduction Act analysis, respectively) and below. The professional skills required to meet these specific burdens also are discussed in section VII.

As discussed above, there are approximately 26 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers will be subject to final rule 211(h)(2)-2. As discussed above in our Paperwork Reduction Act Analysis in section VII above, we estimate that final rule 211(h)(2)-2 under the Advisers Act will create a new annual burden of approximately 1.5 hours per adviser, or 39 hours in aggregate for small advisers.<sup>1901</sup> We therefore expect the annual monetized aggregate cost to small advisers associated with the final rule to be \$317,697.90.<sup>1902</sup>

## **6. Final rule 211(h)(2)-3**

Final rule 211(h)(2)-3 will impose certain compliance requirements on investment advisers, including those that are small entities. Final rule 211(h)(2)-3 will prohibit a private fund adviser (other than an adviser to SAFs with respect to such funds), including indirectly through its related persons, from: (1) granting an investor in the private fund or in a similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets, with an exception for redemptions that are required by applicable law, rule, regulation, or order of

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<sup>1901</sup> Similar to the PRA analysis, we assume that 10% (~3) of all small advisers will conduct an adviser-led secondary transaction on an annual basis.

<sup>1902</sup> This includes the internal time cost and the annual external cost burden, as set forth in the PRA estimates table.



certain governmental authorities and another if the adviser offers the same redemption ability to all existing and future investors in the private fund or similar pool of assets; and (2) providing information regarding the private fund's portfolio holdings or exposures of the private fund or of a similar pool of assets to any investor in the private fund if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a similar pool of assets, with an exception where the adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time. The rule will also prohibit these advisers from providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective investors of the private fund regarding preferential treatment related to any material economic terms, as well as written disclosures to current investors in the private fund regarding all preferential treatment, which the adviser or its related persons provided to other investors in the same fund. The final requirements, including compliance and related recordkeeping requirements that will be imposed under final amendments to rule 204-2 and 206(4)-7, are summarized in this FRFA (section VIII.A. above). All of these final requirements are also discussed in detail, above, in sections I and II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections VI and VII (the Economic Analysis and Paperwork Reduction Act analysis, respectively) and below. The professional skills required to meet these specific burdens also are discussed in section VII.

As discussed above, there are approximately 26 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers will be subject to the final rule 211(h)(2)-3. As discussed above, we estimate that there are no ERAs that meet the

definition of “small entity” and we do not have a method for estimating the number of State-registered advisers to private funds that meet the definition of “small entity.”<sup>1903</sup> As discussed above in our Paperwork Reduction Act Analysis in section VII above, we estimate that final rule 211(h)(2)-3 under the Advisers Act will create a new annual burden of approximately 113.30 hours per adviser, or 2,945.80 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with the final rule to be \$1,081,003.40.<sup>1904</sup>

## **7. Final amendments to rule 204-2**

The final amendments to rule 204-2 will impose certain recordkeeping requirements on investment advisers to private funds, including those that are small entities. All SEC-registered investment advisers to private funds, including small entity advisers, will be required to comply with recordkeeping amendments. Although all SEC-registered investment advisers, and advisers that are required to be registered with the Commission, are subject to rule 204-2 under the Advisers Act, our final amendments to rule 204-2 will only impact private fund advisers that are SEC registered. The final amendments are summarized in this FRFA (section VIII.A. above). The final amendments are also discussed in detail, above, in sections I and II, and the requirements and the burdens on respondents, including those that are small entities, are discussed above in sections VI and VII (the Economic Analysis and Paperwork Reduction Act analysis, respectively) and below. The professional skills required to meet these specific burdens also are discussed in section VII.

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<sup>1903</sup> See *supra* section VIII.D.

<sup>1904</sup> This includes the internal time cost and the annual external cost burden and assumes that, for purposes of the annual external cost burden, 75% of small advisers will use outside legal services, as set forth in the PRA estimates table.

As discussed above, there are approximately 26 small advisers to private funds currently registered with us, and we estimate that 100 percent of advisers registered with us will be subject to the final amendments to rule 204-2. As discussed above in our Paperwork Reduction Act Analysis in section VII above, we estimate that the final amendments to rule 204-2 under the Advisers Act, which will require advisers to retain certain copies of documents required under final rules 206(4)-10, 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, and 211(h)(2)-3, will create a new annual burden of approximately 55.17 hours per adviser, or 1,434.50 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with our final amendments to be \$111,173.75.<sup>1905</sup>

#### **8. Final amendments to rule 206(4)-7**

Final amendments to rule 206(4)-7 will impose certain compliance requirements on investment advisers, including those that are small entities. All SEC-registered investment advisers, and advisers that are required to be registered with the Commission, will be required to document the annual review of their compliance policies and procedures in writing. The final requirements are summarized in this FRFA (section VIII.A. above). All of these final requirements are also discussed in detail in sections I and III above, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections VI and VII (the Economic Analysis and Paperwork Reduction Act analysis, respectively) and below. The professional skills required to meet these specific burdens also are discussed in section VII. As discussed above, there are approximately 489 small advisers currently registered with us, and we estimate that 100 percent of these advisers will be subject to

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<sup>1905</sup> This includes the internal time cost and the annual external cost burden, as set forth in the PRA estimates table.

the final amendments to rule 206(4)-7. As discussed above in our Paperwork Reduction Act Analysis in section VII above, we estimate that these amendments will create a new annual burden of approximately 5.5 hours per adviser, or 2,689.50 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with our final amendments to be \$1,414,173.<sup>1906</sup>

## **F. Significant Alternatives**

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with adopting these rules and rule amendments, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules and rule amendments for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rules and rule amendments, or any part thereof, for such small entities.

Regarding the first alternative, we are adopting staggered compliance dates based on adviser size for certain of the rules. We believe that smaller private fund advisers will likely need additional time to modify existing practices, policies, and procedures to come into compliance. Accordingly, we are providing certain staggered compliance dates, with a longer transition period for smaller private fund advisers.

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<sup>1906</sup> This includes the internal time cost and the annual external cost burden and assumes that, for purposes of the annual external cost burden, 50% of small advisers will use outside legal services, as set forth in the PRA estimates table.

Regarding the fourth alternative, we do not believe that differing reporting requirements or an exemption from coverage of the rules and rule amendments, or any part thereof, for small entities, would be appropriate or consistent with investor protection. Because the specific protections of the Advisers Act that underlie the rules and rule amendments apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Act to specify different requirements for small entities under the rules and rule amendments.

Regarding the second alternative, the restricted activities rule and the preferential treatment rule are particularly intended to provide clarification to *all* private fund advisers, not just small advisers, as to what the Commission considers to be conduct that would be prohibited under section 206 of the Act and contrary to the public interest and protection of investors under section 211 of the Act. Despite our examination and enforcement efforts, this type of inappropriate conduct persists; these rules will prohibit or restrict this conduct for *all* private fund advisers. Similarly, we also have endeavored to consolidate, and simplify compliance with, the rules for *all* private fund advisers. With respect to the rules and amendments other than the restricted activities rule and the preferential treatment rule, we have sought to clarify, consolidate, and/or simplify compliance and reporting requirements consistent with our statutory authority to promulgate rules reasonably designed prevent fraudulent, deceptive, or manipulative acts, or to prohibit or restrict sales practices, conflicts of interest or compensation schemes that we deem contrary to the public interest and protection of investors, by investment advisers. For instance, we have changed the categorization of whether a private fund is a liquid or illiquid fund from a six factor test in the proposal to a two factor text in the final rule in an effort to facilitate compliance with this rule.

Regarding the third alternative, we do not consider using performance rather than design standards to be consistent with our statutory authority to promulgate rules reasonably designed to prevent fraudulent, deceptive, or manipulative acts, or to prohibit or restrict sales practices, conflicts of interest or compensation schemes, that we deem contrary to the public interest and protection of investors by investment advisers.

## **STATUTORY AUTHORITY**

The Commission is adopting final rules 211(h)(1)-1, 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, 211(h)(2)-3, and 206(4)-10 under the Advisers Act under the authority set forth in sections 203(d), 206(4), 211(a), and 211(h) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(d), 80b-6(4) and 80b-11(a) and (h)]. The Commission is adopting amendments to rule 204-2 under the Advisers Act under the authority set forth in sections 204 and 211 of the Investment Advisers Act of 1940 [15 U.S.C. 80b-4 and 80b-11]. The Commission is adopting amendments to rule 206(4)-7 under the Advisers Act under the authority set forth in sections 203(d), 206(4), and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(d), 80b-6(4), and 80b-11(a)].

## **List of Subjects in 17 CFR Part 275**

Administrative practice and procedure, Reporting and recordkeeping requirements, Securities.

## **Text of Rules**

For the reasons set forth in the preamble, the Commission is amending title 17, chapter II of the Code of Federal Regulations as follows:

## **PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940**

1. The authority citation for part 275 continues to read in part as follows:

**Authority:** 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(11)(H), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

\* \* \* \* \*

Section 275.204-2 is also issued under 15 U.S.C. 80b-6.

\* \* \* \* \*

2. Amend § 275.204-2 by:

a. Removing the period at the end of paragraph (a)(7)(iv)(B) and adding “; and” in its place; and

b. Adding paragraphs (a)(7)(v) and (a)(20) through (24).

The additions read as follows:

**§ 275.204-2 Books and records to be maintained by investment advisers.**

(a) \* \* \*

(7) \* \* \*

(v) Any notice required pursuant to § 275.211(h)(2)-3 as well as a record of each addressee and the corresponding date(s) sent.

\* \* \* \* \*

(20)(i) A copy of any quarterly statement distributed pursuant to § 275.211(h)(1)-2, along with a record of each addressee and the corresponding date(s) sent; and

(ii) All records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any statement delivered pursuant to § 275.211(h)(1)-2.

(21) For each private fund client:

(i) A copy of any audited financial statements prepared and distributed pursuant to § 275.206(4)-10, along with a record of each addressee and the corresponding date(s) sent; or

(ii) A record documenting steps taken by the adviser to cause a private fund client that the adviser does not control, is not controlled by, and with which it is not under common control to undergo a financial statement audit pursuant to § 275.206(4)-10.

(22) Documentation substantiating the adviser's determination that a private fund client is a liquid fund or an illiquid fund pursuant to § 275.211(h)(1)-2.

(23) A copy of any fairness opinion or valuation opinion and material business relationship summary distributed pursuant to § 275.211(h)(2)-2, along with a record of each addressee and the corresponding date(s) sent.

(24) A copy of any notification, consent or other document distributed or received pursuant to § 275.211(h)(2)-1, along with a record of each addressee and the corresponding date(s) sent for each such document distributed by the adviser.

\* \* \* \* \*

3. Amend § 275.206(4)-7 by revising paragraph (b) to read as follows:

**§ 275.206(4)-7 Compliance procedures and practices.**

\* \* \* \* \*

(b) *Annual review.* Review and document in writing, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and

\* \* \* \* \*

4. Add §§ 275.206(4)-9 and 275.206(4)-10 to read as follows:

**§ 275.206(4)-9 [Reserved]**



**§ 275.206(4)-10 Private fund adviser audits.**

(a) As a means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative, an investment adviser that is registered or required to be registered under section 203 of the Investment Advisers Act of 1940 shall cause each private fund that it advises (other than a securitized asset fund), directly or indirectly, to undergo a financial statement audit (as defined in § 210.1-02(d) of this chapter (rule 1-02(d) of Regulation S-X)) that meets the requirements of § 275.206(4)-2(b)(4)(i) through (b)(4)(iii) and shall cause audited financial statements to be delivered in accordance with § 275.206(4)-2(c), if the private fund does not otherwise undergo such an audit;

(b) For a private fund (other than a securitized asset fund) that the adviser does not control and is neither controlled by nor under common control with, the adviser is prohibited from providing investment advice, directly or indirectly, to the private fund if the adviser fails to take all reasonable steps to cause the private fund to undergo a financial statement audit that meets the requirements of § 275.206(4)-2(b)(4) and to cause audited financial statements to be delivered in accordance with § 275.206(4)-2(c), if the private fund does not otherwise undergo such an audit; and

(c) For purposes of this section, defined terms shall have the meanings set forth in § 275.206(4)-2(d), except for the term securitized asset fund, which shall have the meaning set forth in § 275.211(h)(1)-1.

5. Add §§ 275.211(h)(1)-1, 275.211(h)(1)-2, 275.211(h)(2)-1, 275.211(h)(2)-2, and 275.211(h)(2)-3 to read as follows:

**§ 275.211(h)(1)-1 Definitions**

For purposes of §§ 275.206(4)-10, 275.211(h)(1)-2, 275.211(h)(2)-1, 275.211(h)(2)-2, and 275.211(h)(2)-3:

*Adviser clawback* means any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements.

*Adviser-led secondary transaction* means any transaction initiated by the investment adviser or any of its related persons that offers private fund investors the choice between:

- (1) Selling all or a portion of their interests in the private fund; and
- (2) Converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

*Committed capital* means any commitment pursuant to which a person is obligated to acquire an interest in, or make capital contributions to, the private fund.

*Control* means the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. For the purposes of this definition, control includes:

- (1) Each of an investment adviser's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the investment adviser;
- (2) A person is presumed to control a corporation if the person:
  - (i) Directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or
  - (ii) Has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities;

(3) A person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership;

(4) A person is presumed to control a limited liability company if the person:

(i) Directly or indirectly has the right to vote 25 percent or more of a class of the interests of the limited liability company;

(ii) Has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the limited liability company; or

(iii) Is an elected manager of the limited liability company;

(5) A person is presumed to control a trust if the person is a trustee or managing agent of the trust.

*Covered portfolio investment* means a portfolio investment that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period.

*Distribute, distributes, or distributed* means send or sent to all of the private fund's investors, unless the context otherwise requires; provided that, if an investor is a pooled investment 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) in order to send to investors in those pools.

*Election form* means a written solicitation distributed by, or on behalf of, the adviser or any related person requesting private fund investors to make a binding election to participate in an adviser-led secondary transaction.

*Fairness opinion* means a written opinion stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair.

*Fund-level subscription facilities* means any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness incurred by the private fund that is secured by the unfunded capital commitments of the private fund's investors.

*Gross IRR* means an internal rate of return that is calculated gross of all fees, expenses, and performance-based compensation borne by the private fund.

*Gross MOIC* means a multiple of invested capital that is calculated gross of all fees, expenses, and performance-based compensation borne by the private fund.

*Illiquid fund* means a private fund that:

- (1) Is not required to redeem interests upon an investor's request; and
- (2) Has limited opportunities, if any, for investors to withdraw before termination of the fund.

*Independent opinion provider* means a person that:

- (1) Provides fairness opinions or valuation opinions in the ordinary course of its business; and
- (2) Is not a related person of the adviser.

*Internal rate of return* means the discount rate that causes the net present value of all cash flows throughout the life of the fund to be equal to zero.

*Liquid fund* means a private fund that is not an illiquid fund.

*Multiple of invested capital* means, as of the end of the applicable fiscal quarter:

- (1) The sum of:

- (i) The unrealized value of the illiquid fund; and
  - (ii) The value of all distributions made by the illiquid fund;
- (2) Divided by the total capital contributed to the illiquid fund by its investors.

*Net IRR* means an internal rate of return that is calculated net of all fees, expenses, and performance-based compensation borne by the private fund.

*Net MOIC* means a multiple of invested capital that is calculated net of all fees, expenses, and performance-based compensation borne by the private fund.

*Performance-based compensation* means allocations, payments, or distributions of capital based on the private fund's (or any of its investments') capital gains, capital appreciation and/or other profit.

*Portfolio investment* means any entity or issuer in which the private fund has directly or indirectly invested.

*Portfolio investment compensation* means any compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the portfolio investment attributable to the private fund's interest in such portfolio investment, including, but not limited to, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments.

*Related person* means:

- (1) All officers, partners, or directors (or any person performing similar functions) of the adviser;
- (2) All persons directly or indirectly controlling or controlled by the adviser;
- (3) All current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and

(4) Any person under common control with the adviser.

*Reporting period* means the private fund's fiscal quarter covered by the quarterly statement or, for the initial quarterly statement of a newly formed private fund, the period covering the private fund's first two full fiscal quarters of operating results.

*Securitized asset fund* means any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders.

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

*Statement of contributions and distributions* means a document that presents:

(1) All capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and

(2) The net asset value of the private fund as of the end of the reporting period.

*Unfunded capital commitments* means committed capital that has not yet been contributed to the private fund by investors.

*Valuation opinion* means a written opinion stating the value (as a single amount or a range) of any assets being sold as part of an adviser-led secondary transaction.

**§ 275. 211(h)(1)-2 Private fund quarterly statements.**

(a) *Quarterly statements.* As a means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative, an investment adviser that is registered or required to be registered under section 203 of the Investment Advisers Act of 1940 shall prepare a quarterly statement that complies with paragraphs (a) through (g) of this section for any private fund (other than a securitized asset fund) that it advises, directly or indirectly, that has at least two full fiscal quarters of operating results, and distribute the quarterly statement to the private fund's investors, if such private fund is not a fund of funds, within 45 days after the end of each of the first three fiscal quarters of each fiscal year of the private fund and 90 days after the end of each fiscal year of the private fund and, if such private fund is a fund of funds, within 75 days after the end of the first three fiscal quarters of each fiscal year and 120 days after the end of each fiscal year, in either case, unless such a quarterly statement is prepared and distributed by another person.

(b) *Fund table.* The quarterly statement must include a table for the private fund that discloses, at a minimum, the following information, presented both before and after the application of any offsets, rebates, or waivers for the information required by paragraphs (b)(1) and (2) of this section:

(1) A detailed accounting of all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the private fund during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation;

(2) A detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period (other than those listed in paragraph (b)(1) of this section), with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and

(3) The amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the adviser or its related persons.

(c) *Portfolio investment table.* The quarterly statement must include a separate table for the private fund's covered portfolio investments that discloses, at a minimum, the following information for each covered portfolio investment: a detailed accounting of all portfolio investment compensation allocated or paid to the investment adviser or any of its related persons by the covered portfolio investment during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented both before and after the application of any offsets, rebates, or waivers.

(d) *Calculations and cross-references.* The quarterly statement must include prominent disclosure regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated and include cross references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.

(e) *Performance.* (1) No later than the time the adviser sends the initial quarterly statement, the adviser must determine that the private fund is an illiquid fund or a liquid fund.

(2) The quarterly statement must present the following with equal prominence:

(i) *Liquid funds.* For a liquid fund:

(A) Annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever time period is shorter;



(B) Average annual net total returns over the one-, five-, and 10-fiscal-year periods; and

(C) The cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.

(ii) *Illiquid funds*. For an illiquid fund:

(A) The following performance measures, shown since inception of the illiquid fund through the end of the quarter covered by the quarterly statement (or, to the extent quarter-end numbers are not available at the time the adviser distributes the quarterly statement, through the most recent practicable date) and computed with and without the impact of any fund-level subscription facilities:

(1) Gross IRR and gross MOIC for the illiquid fund;

(2) Net IRR and net MOIC for the illiquid fund; and

(3) Gross IRR and gross MOIC for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.

(B) A statement of contributions and distributions for the illiquid fund.

(iii) *Other matters*. The quarterly statement must include the date as of which the performance information is current through and prominent disclosure of the criteria used and assumptions made in calculating the performance.

(f) *Consolidated reporting*. To the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading, the adviser must consolidate the reporting required by paragraphs (a) through (e) of this section to cover similar pools of assets.

(g) *Format and content*. 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.

(h) *Definitions.* For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)-1.

**§ 275.211(h)(2)-1 Private fund adviser restricted activities.**

(a) An investment adviser to a private fund (other than a securitized asset fund) may not, directly or indirectly, do the following with respect to the private fund, or any investor in that private fund:

(1) Charge or allocate to the private fund fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, unless the investment adviser requests each investor of the private fund to consent to, and obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser for, such charge or allocation; provided, however, that the investment adviser may not charge or allocate to the private fund fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Investment Advisers Act of 1940 or the rules promulgated thereunder;

(2) Charge or allocate to the private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the adviser or its related persons, unless the investment adviser distributes a written notice of any such fees or expenses, and the dollar amount thereof, to the investors of such private fund client in writing within 45 days after the end of the fiscal quarter in which the charge occurs;

(3) Reduce the amount of an adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders, unless the investment adviser distributes a written notice to the investors of such private fund client that

sets forth the aggregate dollar amounts of the adviser clawback before and after any reduction for actual, potential, or hypothetical taxes within 45 days after the end of the fiscal quarter in which the adviser clawback occurs;

(4) Charge or allocate fees or expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons (other than a securitized asset fund) have invested (or propose to invest) in the same portfolio investment, unless:

(i) The non-pro rata charge or allocation is fair and equitable under the circumstances; and

(ii) Prior to charging or allocating such fees or expenses to a private fund client, the investment adviser distributes to each investor of the private fund a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances; and

(5) Borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client, unless the adviser:

(i) Distributes to each investor a written description of the material terms of, and requests each investor to consent to, such borrowing, loan, or extension of credit; and

(ii) Obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser.

(b) Paragraphs (a)(1) and (a)(5) of this section shall not apply with respect to contractual agreements governing a private fund (and, with respect to paragraph (a)(5) of this section, contractual agreements governing a borrowing, loan, or extension of credit entered into by a private fund) that has commenced operations as of the compliance date and that were entered

into in writing prior to the compliance date if paragraph (a)(1) or (a)(5) of this section, as applicable, would require the parties to amend such governing agreements; provided that this paragraph (b) does not permit an investment adviser to such a fund to charge or allocate to the private fund fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Investment Advisers Act of 1940 or the rules promulgated thereunder.

(c) For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)-1.

**§ 275.211(h)(2)-2 Adviser-led secondaries.**

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6(4)), an investment adviser that is registered or required to be registered under section 203 of the Act (15 U.S.C. 80b-3) conducting an adviser-led secondary transaction with respect to any private fund that it advises (other than a securitized asset fund) shall comply with paragraphs (a)(1) and (2) of this section. The investment adviser shall:

(1) Obtain, and distribute to investors in the private fund, a fairness opinion or valuation opinion from an independent opinion provider; and

(2) Prepare, and distribute to investors in the private fund, a written summary of any material business relationships the adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider;

in each case, prior to the due date of the election form in respect of the adviser-led secondary transaction.

(b) For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)-1.

**§ 275.211(h)(2)-3 Preferential treatment.**

(a) An investment adviser to a private fund (other than a securitized asset fund) may not, directly or indirectly, do the following with respect to the private fund, or any investor in that private fund:

(1) Grant an investor in the private fund or in a similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets, except:

(i) If such ability to redeem is required by the applicable laws, rules, regulations, or orders of any relevant foreign or U.S. Government, State, or political subdivision to which the investor, the private fund, or any similar pool of assets is subject; or

(ii) If the investment adviser has offered the same redemption ability to all other existing investors, and will continue to offer such redemption ability to all future investors, in the private fund and any similar pool of assets;

(2) Provide information regarding the portfolio holdings or exposures of the private fund, or of a similar pool of assets, to any investor in the private fund if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a similar pool of assets, except if the investment adviser offers such

information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time.

(b) An investment adviser to a private fund (other than a securitized asset fund) may not, directly or indirectly, provide any preferential treatment to any investor in the private fund unless the adviser provides written notices as follows:

(1) *Advance written notice for prospective investors in a private fund.* The investment adviser shall provide to each prospective investor in the private fund, prior to the investor's investment in the private fund, a written notice that provides specific information regarding any preferential treatment related to any material economic terms that the adviser or its related persons provide to other investors in the same private fund.

(2) *Written notice for current investors in a private fund.* The investment adviser shall distribute to current investors:

(i) For an illiquid fund, as soon as reasonably practicable following the end of the private fund's fundraising period, written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund;

(ii) For a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund, written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund; and

(iii) On at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided in accordance with this section, if any.

(c) For purposes of this section, defined terms shall have the meanings set forth in §

275.211(h)(1)-1.

(d) Paragraph (a) of this section shall not apply with respect to contractual agreements governing a private fund that has commenced operations as of the compliance date and that were entered into in writing prior to the compliance date if paragraph (a) of this section would require the parties to amend such governing agreements.

By the Commission.

Dated: August 23, 2023.

**Vanessa A. Countryman,**

*Secretary.*