PRIVATE FUND RULES PODCAST
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Genna Garver:

Welcome to our podcast. I'm Genna Garver. I'm a private funds and investment management partner at Troutman Pepper. Here with me today is Amber Allen, general counsel at Fairview Investment Services. Thanks for joining us as we discuss some of our top takeaways and suggested next steps for the new private fund rules adopted by the SEC at their August 23rd, 2023 open meeting.

As some of you may know, while the SEC relaxed certain requirements included in its rule proposal, the final rules will significantly increase regulatory requirements for private fund advisors. These changes are coming at a time when many chief compliance officers and compliance professionals in general are experiencing significant regulatory fatigue. There are numerous additional proposals still on the SEC's regulatory agenda for the season. Today's discussion is intended to help you ease into the regulatory changes by providing some highlights and key takeaways.

Under the new rules, registered private fund advisors must provide quarterly statements to fund investors with details on performance and fees and expenses, and obtain an annual audit for private funds and comply with certain requirements for advisor-led secondaries, including obtaining a fairness opinion or evaluation opinion. The rule heightens regulation for all private fund advisors though regardless of their registration status, including a prohibition on entering into specified arrangements with private funds regarding certain fee and expense allocation arrangements unless the advisor can satisfy certain conditions. Also, a prohibition on providing preferential treatment to private fund investors regarding redemption rights and portfolio holdings disclosures unless those same arrangements are offered to all other investors. Then finally, a prohibition on providing any other type of preferential treatment to investors unless existing and prospective investors receive written notice of the same.

The SEC also amended the books and records rules as well as the compliance rule for registered advisors, which we'll discuss later. These rules are super complex and the devil really is in the details. I'm lucky to have Amber here with me, not just to be here for this podcast, but literally by my side all week as we've digested these rules together.

Amber, with that, would you like to introduce yourself?

Amber Allen:

Thanks, Genna. It's great to be here. I'm Amber Allen, and I serve as the general counsel and executive vice president of Fairview, which provides compliance and regulatory support services to investment advisors.

For those of you who haven't jumped into the rule text or the adopting release, check out our client alerts, both of which will be linked in our podcast post. Genna and I will

also be doing a more in-depth article and discussing the rule with an SEC staff member at the NSCP National Conference in Dallas in October. Please stay tuned and join us for that.

Let's start on a positive note. Genna, what's the biggest relief in the final rules compared to the proposed version?

Genna Garver:

Yes, there is some good news. My biggest relief is the change from flatly banning side letters and prohibiting certain activities to just restricting the use of side letters in certain activities, especially because what was prohibited activities and which is now referred to as restricted activities and preferential treatment rules applied to all private fund advisors regardless of their registration status.

To engage in restricted activities, advisors will need to comply with the condition set forth in the rule as well as any applicable provisions of their fund documents, which may be more restrictive or prohibitive in nature than the rule. For example, expense provisions in fund documents may or may not authorize the allocation of advisor compliance costs to the fund, notwithstanding the rules and restricted conditions for doing so.

The fact that each restricted activities rule requires a somewhat different path to compliance, which may be different than what's set forth in the fund documents, makes these rules really challenging for all, but particularly for exempt reporting advisors or other non-registered advisors that may not have the required written policies and procedures that registered advisors have or a dedicated compliance person.

Amber Allen:

While this isn't the first rule that applies to ERAs, it will likely be the most difficult for ERAs to actually implement. We work with a lot of ERAs to develop policies and procedures to meet existing expectations like the pay to play and code of ethics requirements. But as you mentioned, a lot of ERAs, and especially those that don't plan to register with the SEC, have limited compliance resources which could lead them to seek outside help, especially for rules as complicated as these.

Genna Garver:

It doesn't sound like it's all positive. That's the best that we have to offer there. What's giving you the biggest headache?

Amber Allen:

There are multiple things, but let's start with the preferential treatment. Managing the preferential treatment requirement will be a challenge for advisors. There are a variety of restrictions and notices required. In particular, the requirements for the transparency requirements will pose the most unique challenges because they impact one-on-one discussions or subsets of investors. That could even include LPACs, for example.

Managers are going to have to thoughtfully work through how to communicate with investors in those types of settings.

Under the rule, advisors are restricted from providing investors with information on portfolio holdings of the fund or a similar pool of asset if the advisor reasonably expects the information to have a material negative effect on other investors in the fund, unless the advisor offers the same information to all investors in the fund and any similar pool of assets.

That's a lot to unpack. Let's start with how do you determine if there's a material negative effect. The ability to redeem is an important part of the consideration. If investors receive preferential treatment to information and they have the ability to redeem, it's more likely to be viewed as a material negative effect. Unfortunately, it's not really clear what other factors other than redemption rights need to be considered. It's also worth noting that the SEC did not provide an exemption for closed-in funds from this component of the rule because they may still permit redemptions in certain limited circumstances.

Once this type of information is shared, the advisor will have to meet the exception, which requires an advisor to offer the information to all investors in the private fund and any similar pool of asset at the same time or substantially at the same time. A similar pool of assets is defined under the rules. That's a more simple analysis. It includes an investment vehicle other than a registered investment company with substantially similar investment policies, objectives, or strategies to those of the private funds that is managed by the advisor or its related persons.

Unfortunately, there isn't much guidance on what the same or substantially similar time means under the rule. This means that navigating one-on-one discussions, bespoke reporting, that's going to be a challenge and will require a lot of documentation. Some advisors may ultimately decide to stick to a script when having one-on-one discussions with investors. That's going to require a lot of thoughtful planning. What about you, Genna? What's your biggest headache?

Genna Garver:

Well, I thought I had my answer and then having just listened to you unpack that, I'm like, thank goodness there's a mute button so no one can hear me cry. It's definitely complicated, but for me, if I have to say something different than you, I would say it's probably a tie. I would say number one is how to deal with the two proposed prohibited activities that didn't make it into the final rule. Those are the prohibitions on charging fees for unperformed services and seeking certain waivers or indemnification.

According to the adopting release, the SEC believes that those prohibitions were necessary to codify in a rule in light of the advisor's fiduciary duty. It's not clear if disclosure alone could satisfy the fiduciary duty with respect to fees for unperformed services. I think that's a big point that I know the industry is really focused on right now. It's also not clear what impact that SEC's clarifications in the adopting release will have on industry practices, particularly because the adapting release itself is not the rule. It's

certainly guidance, but it's got this strange status, so to speak, under law. But it's clearly the SEC's view of current law.

Importantly the legacy status, which we haven't really talked about yet, and we will, but which is granted under the final rules as what was previously known as grandfathering, does not apply to the guidance on these two prohibited activities. Nobody's really escaping these issues of interpretation and what to do next on those points. That's definitely the number one headache with 20 million subparts.

I'm also concerned about how the adapting releases discussion on LPACs (Limited Partner Advising Committees) could impact industry practice for using LPACs to address certain conflicts of interest not addressed by the rules, including using LPACs as a means of obtaining informed consent from the fund regarding activities such as principal transactions and changes of control.

It really, it's hard to point to just one thing. There is so much here and it's still early days, so I expect that a lot of these points are going to be well vetted and teased out over time, but it may take time to come to ultimate conclusions on how to proceed.

Amber, what were your biggest surprises in the final rule?

Amber Allen:

While despite the 660-page adopting release, the final rule did peel back some of the requirements that were included in the initial proposal. That's good news. It's clear that industry comment affected the final rule here, which comes as a welcome relief for a lot of people in the industry. One of the material changes is that securitized asset funds are generally not included under the rule.

Securitized asset funds include any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders. The definition does not include traditional hedge funds, PE, venture capital funds, real estate and credit funds. Securitized asset funds aren't required to follow the rules that govern quarterly statements, restricted activities, advisor-led secondaries, preferential treatment or audits. But if the advisor advises non-securitized asset funds, those funds would be subject to the requirements.

Genna, what do you think some of the most common questions are that you expect to hear from clients?

Genna Garver:

That's a fantastic topic and I can't wait to dive into that. Of course, I also can't help myself, but first just plead to our listeners and industry participants to get involved in the regulatory rulemaking process because, as you said, the final rule does reflect the comments received by the industry and members of Congress. I think having that diversity of thought in the rulemaking process is critical for having sensical rules and with reasonable approaches having not a blanket exception, but a pretty chunky exception for securitized asset funds. That was a surprise for me, legitimately. I was not

involved in any lobbying efforts for that and didn't know. You see how you can get such significant relief in the comment process.

There are a lot of more proposals out there. Anyone who has not yet commented or gotten involved, I definitely encourage you to do so. There are a number of ways to do that on an anonymous basis as well. It looks like from the adopting release that the SEC considered all comments received to date, not just those that came within the comment period, which begs the question what's the point of the comment period? But I just wanted to throw that plug in there for democracy and getting involved in the process.

But now I do want to respond to your question. Clients are definitely asking questions already, which I think is somewhat different than the marketing rule. We had an 18-month compliance period for the marketing rule. This rule too has staggered compliance periods. Some are a year or 18 months. I think it's interesting how we've learned so much in the past few years about rule implementation.

We are already getting questions. I think the first one is do these rules apply to me? The new rules apply to US registered advisors and may apply to non-US registered advisors, although the adopting release is pretty murky on the application of the rules for non-US advisors pages 49 to 51. If you want to have a good time this weekend, check it out. But I would say that clearly the written compliance review requirement applies to all SEC registrants regardless of whether they advise private funds. With the exception of that written compliance review rule, all of the other new rules apply only to advisors that have private funds. Then only certain of those new rules apply to private fund advisors that are not required to be registered, such as an exempt reporting advisor or a foreign private advisor.

That means if a real estate fund manager exclusively advises funds that are excluded from the Investment Company Act solely by virtue of 3(c)5, the private fund rules do not necessarily apply. But you have to be careful because you have a 3(c)5 fund that also satisfies another exclusion from the definition of an investment company, and you treat that fund as a private fund for one purpose under the advisors act, you're going to have to treat it as a private fund for all purposes under the advisors act, including these new rules. You definitely have to be careful there.

The restricted activities and preferential treatment rules apply to all private fund advisors regardless of their registration status. Exempt reporting advisors really do want to focus in on those rules.

What questions are you seeing?

Amber Allen:

We're expecting that firms will want to know, completely agree they're going to want to know about exceptions available. Firms are going to want to try to limit the changes that they need to make, especially because these rules are so comprehensive and are going to require a lot of changes, and as a result, a lot of additional expenses. Firms are going to want to know how to limit those.

We expect to receive a lot of questions, speaking of expenses, on fee allocation and how to meet the restricted activities rule, especially for fees that are related to portfolio investments by multiple funds that the advisor wants to allocate on a non-pro rata basis. In this type of a scenario, a firm would need to document its rationale for determining how the non-pro rata charge is fair and equitable. They would also need to obtain client consent, which is much easier said than done.

Another question that I'm expecting to hear, especially on the heels of the new marketing rule, is how usage of these quarterly statements will interplay with the marketing requirements. This came up in the comment letters. As a result, the SEC noted in its adopting release that the marketing rule and its specific protections generally will not apply in the context of a quarterly statement. Quarterly statements are generally only going to be used for investors and wouldn't be offering advisory services. In that case, it would be outside of the scope of the marketing role. However, if a quarterly statement is used for marketing purposes, maybe it's included in a pitch book, then an independent analysis would need to be done to determine compliance with a marketing rule.

Where the analysis would get more complicated is if an advisor wants to use the quarterly statement in addition to other performance figures in marketing. In that case, the firm would need to be really cautious about determining what disclosures would need to be added and if policies would need to be updated.

Genna, what types of questions are you expecting clients to ask about fund agreements?

Genna Garver:

I think the one that's already come up is whether the new rules mean they can charge the fund for advisor-related compliance costs. Assuming you comply with the conditions of the final rules, the rules do permit the allocation of certain costs to the funds. However, you still need to comply with your fund documents which may have more restrictive or prohibitive terms. The rules really create a new baseline floor for permissibility.

To the extent that you want to be able to engage in the restricted activities and your fund documents preclude that, then you may need to update your documents, which in many cases will meet an amendment that will require some sort of investor consent. I think with the ability to engage in those activities, it's fairly clear when you would need to consider changing your documents with other aspects of the rule that we've already discussed, particularly with respect to the two prohibited activities that were left out of the final version. That's obviously going to take a deeper analysis.

Let's shift now to recommended next steps. We've just come through the marketing rule implementation, which we thought had a very long compliance period, at least initially, like early days we thought that. I feel like it literally just ended. Now that you've raised the point that there could be interplay between the marketing rule of the quarterly reports, my head's going to explode because I'm like, "Wait, we just did that. It's over. What are we doing? Don't go back. Go forward." But, here we are.

The marketing rule, as you remember, some people started straight out of the gate, got really into it. Others waited. It seemed like many of the tricky points weren't resolved until the very late days. To be fair, even after the required compliance date, which is why we ended up with an FAQ in January, given that experience, what do you think advisors should be doing now to prepare?

Amber Allen:

That's a great question and also a great point about the marketing rule. Don't wait. I'll start with the changes that are going to require the quickest action. That's under the compliance rule, actually.

As part of the adopting release, an amendment was made to the compliance rule, which codifies requirements for all advisors that are registered or required to be registered to conduct and document an annual compliance review in writing. This might come as a surprise to advisors that don't advise private funds and wouldn't necessarily expect their compliance programs to be affected by this regulatory update. Luckily, most advisors are already doing this. But if you aren't, the compliance date is 60 days from publication of the rule and the federal register.

In the adopting release, the SEC did note that the purpose of the amendment is to enable the SEC staff to review documentation as part of an exam and confirm that an advisor is complying with its policies and procedures. Annual reviews would need to be maintained as part of the firm's books and records for at least five years after the end of the fiscal year end in which the review was completed.

Genna, what are some of the other steps that firms will need to take next?

Genna Garver:

Amber, thanks. That was a very important first step because I've been concerned that there hasn't been great education or outreach on the written compliance review requirement. I think if you're not a private fund advisor, I mean, look, everyone's really busy. There's plenty to focus on aside from this rule. It may be that they aren't focusing on things that are specific to private fund advisors. This might be a miss, but there is a very tight compliance date. I think it's important that we all keep screaming about that.

With respect to the private fund rules, I would say step one is prepare to document your road to implementation. This point too is a lesson learned from the marketing rule. We saw examiners over the past year really dig in on how compliance implemented the marketing rule. If you don't document the good work you're doing to implement a rule, then it didn't happen. I mean, I think that's the golden rule of compliance.

It's not something we're used to thinking about. We're used to thinking about the end results of the good work done to get the rules implemented, but we have certainly seen questions regarding training and work done to flush out particulars that may or may not be in the compliance manual. Maybe it's on the side about calculation methodologies for performance or what have you. I think it is a different mindset about the kinds of

questions you might get on an exam and the documentation you want to have to substantiate the good work that you're doing to comply in that pre-compliance period.

Then based on your registration status, I think the next step is to determine which parts of the rule apply to you. I think everyone's going to have to deal with some aspect of the rules because legacy status is only available if the rule would require amendments to your fund docs and only for advisors looking to engage in activities covered by the prohibitions aspects of the preferential treatment rule and aspects of the restricted activities rule requiring investor consent.

It's a really narrow, I don't want to say grandfathering legacy or whatever, I don't know, we'll have to come up with a different word for that, but you should not assume, "Oh, I'm an existing fund manager and my offering period's expired. I'm not looking to raise dollar fund anytime soon, so I don't have to worry about these." That is not true. Definitely understand your status and which rules apply. Then determine if you have legacy status with respect to your existing funds regarding those restricted activities and preferential treatment rules.

For existing funds, you want to look at expectations regarding subsequent closings and activities. Generally, that would require amendments to your documents. Also, if you intend to use your existing fund documents as a template for your next fund, which is not uncommon, especially in the private equity rule with different vintages, you'll want to identify provisions that might be inconsistent with the rule or that you may want to change to come into alignment with the rules where you might be able to engage in more activities than your documents currently provide.

I think on that last point, you really should take a look at your fund documents, not just with a negative lens to see what's wrong, but also to really understand the authority that's granted in the fund documents to charge certain fees or what procedures are currently required for engaging in certain restricted activities. You may want to, again, seek to change or change for the future those provisions to match the paths to compliance required under the rule, which may be less draconian.

Amber, what would you suggest?

Amber Allen:

Great point. On the compliance front, once you've determined your scope of how the rules will apply to your firm, an advisor should look at their practices, determine what updates are needed to comply with the new rules, and based on that analysis, update their written compliance policies and procedures.

Some firms might already be following some of these requirements in spirit, but they still need to update their written compliance manuals. As we know, there's a lot of interconnection between compliance manuals and fund documents and ADV disclosures.[1] We want to make sure that all of those terms align and that they're updated to reflect any changes required under the new rules.

[1] Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities authorities.

Conduct training, that'll be a really important component as well. In certain cases, someone on the sales team may not be aware of some of the updates required. Without training, it's possible that they'll be using either terms or agreements or information that is inconsistent with the rules. It's really important to make sure that your entire team is aware of the upcoming changes, any changes in documentation that you'll have, and that you have a thorough plan for any future fund launches.

Reach out to your service providers. If you have a fund administrator, they're going to be instrumental in meeting the quarterly statement requirement. Be sure to coordinate with them. Then start the selection process for other service providers. For example, if you think that you might be doing secondaries for non-legacy funds post-compliance date, go ahead and start the selection process for auditors for those funds that don't currently receive them, and for fairness opinions or evaluation opinion service providers.

Genna Garver:

Excellent points. There may be some fund managers who need help preparing those quarterly statements as well. I suspect a number will need to be looking to outsource or to get assistance on that.

Just fascinating, especially the overlap with the marketing rule and making sure that all team members are aware of the interplay between the two. You can certainly imagine a scenario where someone in marketing might include a quarterly statement in the marketing piece not realizing the interplay with those rules, or what have you. I know the exam teams will certainly be focused on the extent of training as part of that path to implementation as we saw in a marketing rule, and particularly whether everyone was trained or just teams that deal with the rules on a day-to-day basis.

Just fantastic points, Amber.

Amber Allen:

Thank you so much for the time, Genna. It was great to be here today.

Genna Garver:

Thank you so much, and thanks to our listeners. Please keep an eye out for our upcoming article and join us in October for our panel discussion in Dallas at the NSCP national meeting. Until next time, thank you so much.

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