GROOM LAW GROUP

Publications

SEC Private Fund Adviser Rules May Impact Benefit Plan Investors

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On August 23, 2023, the Securities and Exchange Commission ("SEC") voted three to two to adopt a package of new final rules, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance* (the "Private Fund Rules"). 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 Investment Advisers Act of 1940 (the "Act") but the SEC otherwise has historically had limited oversight over private fund managers.

The Private Fund Rules were enacted to address SEC concerns that the existing private fund regulatory structure left investors subject to risks and harms related to lack of transparency, conflicts of interest, and lack of governance mechanisms. While the Private Fund Rules represent the SEC's most significant effort to regulate private funds, they are less onerous than the reforms the SEC had initially proposed on February 9, 2022.

These rules will be of interest to plan sponsors and fiduciaries of defined benefit plans that include private fund investments as well as investment advisors and consultants and fiduciaries of defined contribution plans that are considering private fund investments (whether private equity, private real estate, or other structures). In fact, the SEC specifically raised individual's indirect exposure to private funds "through those individuals' participation in public and private pension plans, endowments, foundations, and certain other retirement plans" as a rationale for the rules. The Private Fund Rules will provide more transparency and uniformity around private fund reporting.

Plan fiduciaries may benefit from revisiting their investment review framework and considering whether the Private Fund Rules shift priorities in future side letter negotiations. If you have questions or would like additional detail, please contact your regular Groom attorney.

Commentary

In the guidance, the SEC expressly acknowledges the role that private funds play in helping to close America's retirement gap. Specifically, the SEC describes today's landscape where retirement fiduciaries have had to diversify away from traditional asset classes to satisfy retirement funding needs (with a particular focus on governmental plans) –

[P]rivate funds and their advisers play an increasingly important role in the lives of millions of Americans planning for retirement.1While 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. 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. In particular, public pension plans face a stark funding gap and many have turned to private funds in an attempt to address underfunding problems. 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.

The Private Fund Rules focus on six areas of private fund administration:

- Side Letters
- Quarterly Statements
- Activity Related Limitations (e.g., charging the fund for investigation-related expenses where a court finds there to have been a violation of the Act)
- Adviser-Led Secondary Protections
- Annual Financial Statement Audits
- Recordkeeping

The Private Fund Rules have been controversial since they were proposed, and we expect there may be litigation alleging that the package exceeds the SEC's authority. However, many of these changes will likely be of interest to ERISA and non-ERISA plan fiduciaries, and we would expect that plan fiduciaries may want to engage with their legal advisers, consultants, and managers to discuss compliance with portions of the Private Fund Rules even if they are ultimately modified or struck down given the overlay of ERISA or state fiduciary rules.

More Detail

Below, we briefly describe in more detail changes in the order that they are likely to be of interest to retirement plan fiduciaries.

Side Letter Reforms

The SEC expresses concern that larger investors can negotiate more favorable terms than smaller investors – often at the expense of smaller investors. Generally, the Private Fund Rules seek to address this SEC-perceived inequity through disclosure. For prospective investors, managers are required to provide written notice that provides specific information about any material economic terms it has granted to other investors. Similarly, the Private Fund Rules require disclosure of material economic referential terms to all investors.

For certain terms, the SEC requires more than disclosure. For example, private fund managers are prohibited from granting redemption rights to any investors that the manager would expect to have a material negative effect on other investors (except in limited circumstances, such as if required by law or to redeem ERISA investors to avoid holding "plan assets"). Similarly, managers are prohibited from providing bespoke information regarding portfolio holdings or exposures if providing such information would be expected to have a negative impact on other investors. For both liquidity and information, managers are permitted to agree to amended terms with an investor if they make that term available to all investors.

Quarterly Statements

The SEC describes today's private fund reporting landscape as opaque and inconsistent between funds. To mitigate this perceived problem, the SEC is requiring managers to provide quarterly statements describing (1) fees and expenses, (2) portfolio fees, and (3) performance.

Each quarterly statement will be required to contain:

- A table of fees listing (1) all compensation, fees, and other amounts paid to the adviser and related parties, (2) an accounting of all other fees broken down by category (e.g., accounting), and (3) any offsets or rebates that the fund is carrying forward that will be deducted from future fees or expenses.

- A detailed accounting of portfolio investment compensation allocated to the adviser or related parties.
- Performance information calculated over specific periods using standardized calculation methodologies. The SEC provides two frameworks depending on whether a fund is liquid or illiquid, as defined in the rule.

However, the SEC made it clear that funds may provide additional reporting on a more frequent basis than quarterly and that the fund-level reporting requirements do not prevent a manager from providing (or causing to be provided) personalized information or other customized information to supplement the standardized baseline level of fund-level information required to be included in the quarterly statements, provided that such additional information complies with the other requirements of the Act.

Activity Related Limitations

The SEC identified a handful of activities that either require the manager disclose and obtain consent from investors or that are strictly prohibited. These include:

- Funds cannot reimburse managers for expenses related to investigations where a court or governmental authority imposes sanctions for a violation of the Act.
- Prior to a fund paying a manager's expenses related to an investigation, the fund must request and receive written consent from a majority of the fund's interests, excluding related party interest holders.
- Managers cannot require the fund to bear the cost of regulatory, compliance, or other examination related fees unless the manager providers written notice and discloses the dollar amount to investors within 45 days of the expense being incurred.
- Managers cannot reduce the amount of performance or other fees subject to clawback to account for taxes unless the manager provides written notice within 45 days after the end of the quarter in which the adviser clawback occurs.
- Managers are prohibited from charging non-pro rata portfolio investment expenses unless (1) the allocation method is fair and equitable and (2) prior to implementing the allocation method, the manager provides a description of both the method and why it is fair and equitable.
- Managers are prohibited from borrowing from a fund unless the manager (1) provides a description of the material terms, (2) requests consent, and (3) receives consent from a majority of the fund's interests, excluding related party interest holders.

Adviser-Led Secondaries

The SEC also expresses concern about the valuations that may be used when managers give investors the choice between selling all or a portion of their interest in a fund or converting into an interest in another fund managed by the same manager. To address these SEC concerns, the SEC requires that the manager obtain a fairness opinion from an independent opinion provider. In addition to obtaining a fairness opinion, the manager must also distribute to investors a written summary of any material business relationships the adviser or related parties had in the prior two years.

Annual Audits

Fund managers will be required to take reasonable steps to ensure that any funds they advise or manage have annual financial statement audits that comply with Act Rule 206(4)-2, the custody rules.

Recordkeeping and Annual Compliance Review

To enforce these rules, the SEC requires additional documentation and records retention.