US SEC reforms uncovered: what it means for private markets

On Wednesday 23 August 2023, the US Securities and Exchange Commission (SEC) approved its new Private Fund Advisor (‘PFA’) rule under the Investment Advisers Act of 1940, as *Ore Adegbotolu* now reports.

The new rules, which will follow the SEC’s standard 18-month adoption window, 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.

The new rules will require private fund advisers registered with the SEC to:

- Provide investors with **quarterly statements** detailing private fund performance data, the cost of investing in the fund, fees and expenses paid by the fund, as well as certain compensation and other amounts paid to the investor.
- Ensure each private fund they advise undergoes an **annual audit** that meets the requirements of the audit provision in the Advisers Act custody rule (rule 206(4)-2)). These audits will provide an important check on the adviser’s valuation of private fund assets and protect private fund investors against the misappropriation of fund assets.
- Obtain a fairness opinion or valuation opinion in connection with an adviser-led **secondary transaction**. Advisers will need to provide this opinion when offering existing fund investors the option between selling their interests in a private 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.

Once the rules are enacted, private fund advisers will be prohibited from engaging in certain activities which are deemed to be contrary to the public interest and protection of investors, unless certain disclosures are provided to investors. In some cases, investor consent will be required. Additionally, the new PFA rules would prohibit advisers from providing certain types of preferential treatment that have a material negative impact on other investors, while other types of preferential treatment will need to be disclosed to current and prospective investors.

The reforms are among the most sweeping in the history of the private funds market and will bring significant change to the alternatives industry. From our perspective, the adopted PFA rules are an understandable development, given how rapidly the industry is evolving, especially given the rise in complexity of some activities within the private markets.

In July, prior to the approval of the PFA rules, we invited several industry experts onto the Alternative Insight podcast, to discuss the proposed reforms, as they were then. Chaired by Lynne Westbrook, you can now listen to this episode on the media player below.

"The mood on the street has been one of bewilderment in as much as, why is the SEC focusing so much attention on these clients which are sophisticated investors," Paul Marino, Partner at Sadis & Goldberg LLC, told us.

Neal Prunier, Senior Director of Industry Affairs at the Institutional Limited Partners Association (ILPA) added, "Generally, LPs are supportive of this. They've noted that some developments in the private equity market have not been able to take place at the level you would anticipate, and so have been looking for more support top-down from government regulators to try and level the playing field and the dynamics between LPs and GPs."

However, John Beczak, Partner & Chief Financial Officer at Resource Capital Funds offered a note of caution on the reforms. "From a GP's perspective a lot of these rules have good practicality for investors, but the level of transparency that's being asked, and the amount of time and effort it will take to implement every rule as it's currently proposed, is significant for every GP. For small and mid-market GPs, that cost becomes exponentially greater. For smaller GPs, it could be a practical point of them not being able to stay in business. A lot of the cost burden will be borne by the GP themselves, but some of that will be allocated down to the LPs, which could reduce their net return."

There are still areas of concern in respect of the new PFA rules. One raised on the podcast related to side-letters and the risk that, if the rules were implemented as planned, could lead to the elimination of side-letters altogether. "76% of LPs have told us they couldn't operate without a side-letter," ILPA's Neal Prunier said. "So that's why we've pushed forward some recommended adjustments to the language in the side-letter rule."

Now that the final PFA rule has been adopted, despite some changes, there are lingering concerns regarding side-letters now due to the ambiguity around what is considered to have a material negative effect in illiquid private equity funds where redemptions are extremely rare.

Other concerns remain, including the sharp turnaround times associated with quarterly statements. 45 days post quarter-end will be challenging, particularly at year end when firms are undertaking their annual audit cycle. This will have a significant burden on the public accounting industry, and on administrators, which will doubtless require increases in resourcing to accommodate.

"All our funds maintain standard reporting deadlines," John Beczak**,** Partner & Chief Financial Officer at Resource Capital Funds concluded. "We adhere to those timelines, but having the practical consideration of accelerating timings and accelerating valuation committee meetings, and accelerating the reporting review cycle is a burden on my team and also my administrator."

At a conceptual level, we believe these developments are welcome, as vibrant and sustainable markets benefit from strong regulation and that in turn promotes investor confidence. However, we should also acknowledge that these changes are going to place a greater burden on fund managers who are already having to cope with a more fraught fundraising environment and a confluence of operational headwinds. It is, therefore, vitally important that these changes are implemented in a considered manner, so the industry can avoid a "cliff-edge" moment.

If you'd like to discuss what the SEC reforms mean for your business in more detail, and how Aztec can support you in implementing and adhering to them, please contact **Ore** or **Lynne** directly.

If you like what you heard, head to Spotify, Apple Podcasts or wherever you listen to podcasts, find Alternative Insight podcast by the Aztec Group and hit the subscribe button, so that you receive all future episodes as soon as they're published!