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NEW SEC PRIVATE FUNDS RULES: DATA, REPORTING AND COMPLIANCE CHALLENGES

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In late 2023, the Securities and Exchange Commission (SEC) adopted new rules (Private Fund Rules) under the Investment Advisers Act of 1940, which will have a significant impact on fund sponsors and the private funds they advise.

These rules are intended to increase investors' visibility into certain adviser practices and to protect investors by promoting increased transparency, competition and efficiency in the private funds market. As adopted, the rules present a material increase in the regulatory compliance and reporting obligations of private fund advisers.

The rules apply to all private fund advisers such as private equity and buyout funds, hedge funds, fund of funds and venture capital funds, as well as to registered investment advisers (RIAs) that advise private funds.

The new Private Fund Rules are aimed at increasing transparency to and protection of investors in three primary areas. First, private funds and their sponsors are required to provide additional disclosures to all investors regarding preferential treatment of certain investors. Second, these rules restrict certain practices such as borrowings and allocation of expenses and fees by private funds and their sponsors in the absence of additional disclosure to and consent from investors. Third, SEC-registered advisers must provide investors with

not only quarterly performance, fee and expense statements but also with annual audited financial statements for the private funds they advise.

For advisers whose principal office is outside the US, none of the Private Fund Rules apply – other than the written annual review requirement for SEC-registered advisers. This exemption applies whether the non-US adviser is an exempt reporting adviser, foreign private adviser or SEC-registered adviser. However, the exemption would not apply with respect to any US-domiciled funds that the adviser manages.

"Asset managers would be wise to have a comprehensive strategy and overarching plan for all data and reporting that a fund must do."

Complex quarterly reporting requirements

The SEC indicates that the intent of the rules is "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". The rules require that advisers must provide quarterly statements detailing information regarding performance, fund fees and expenses, and compensation received by the adviser or its related persons for each portfolio company.

In a table format, advisers must provide in detail all compensation, fees and other amounts allocated or paid to the 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 line items such as management, advisory, sub-advisory or similar fees or payments and performance-based compensation.

Furthermore, advisers are required to provide a detailed accounting of all fund 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 (e.g., organisational, accounting, legal, administration, audit, tax, due diligence and travel expenses).

There is no exception from this requirement for non-material expenses – private fund advisers

are prohibited from excluding de minimis expenses, grouping smaller expenses together into broader categories, or identifying any expenses as 'miscellaneous'. To the extent that a fund expense could also be characterised as adviser compensation, it must be disclosed as adviser compensation rather than as a fund expense. For example, compensation paid to a related person who provides consulting, legal or back-office services should be categorised as adviser compensation.

Additionally, all fees, expenses and other compensation reported on a quarterly statement must be reflected both before and after any offsets, rebates or waivers. Fee reductions applicable only to a subset of investors should be listed with an appropriate description, but the identity of the subset of investors does not need to be disclosed.

For private fund RIAs, advisers will need to develop a clear-cut plan for gathering and computing expense information in quarterly statements. Given the granularity required in the reporting, private fund

RIAs should consider instituting a process to identify and track all expenses as fund-or adviser-related expenses. This process will likely require changes not only to internal operations, but also adjustments to a private fund RIA's interaction with service providers and the manner in which those expenses are tracked.

For illiquid funds, the quarterly statement rule requires advisers to compute and present performance both with and without the impact of fund-level subscription facilities. While the SEC acknowledges that performance calculated with the impact of a subscription facility usually reflects the actual return to investors, the SEC seems to be clearly concerned that 'levered' performance figures, alone, have the potential to mislead investors.

Although there are several prescriptive provisions regarding the computation and presentation of investment performance, there is no requirement in the marketing rule to compute and present in an advertisement the hypothetical performance that a fund would have earned absent the effect of a fund-level subscription facility. However, the discussion in the SEC's adopting release of the rules suggests that staff may interpret the marketing rule's general prohibitions to require similar performance presentations in advertisements.

The Private Funds Rules require that quarterly statements 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 (for fund-of-funds, within 75 days after the end of each of the first three fiscal quarters of each fiscal year of the private fund and 120 days after the end of the fiscal year of the private fund).

If it is a newly formed private fund, the initial quarterly statement is required to be issued after the first two full fiscal quarters of operating results. By standardising the calculation and disclosure of performance metrics, these proposals are intended to make it easier for investors to compare adviser performance data. However, these new rules will clearly also make regulatory compliance more costly and cumbersome for advisers.

The only bright spot, if any, associated with the quarterly reporting requirements under the Private Funds Rules is that the SEC's previously stated definitions 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.

Reporting challenges

We believe advisers will find it quite challenging to prepare and produce a quarterly fund statement within 45 days after the end of each fiscal quarter. In

doing complex and structured regulatory reporting, such as under the new quarterly statements rule, advisers face in particular the difficulty that their private fund data is widely scattered across funds, structures and clients.

Typically, an adviser's data resides in multiple places, such as in accounting systems, administrators, custody banks, prime brokers and spreadsheets. As a result, most advisers do not have the data needed to do regulatory reporting in an aggregated and normalised form, such as a data warehouse. Furthermore, many advisers still rely for critical reporting (including regulatory reporting) on largely manual processes that depend on Excel spreadsheets passed between several internal groups, such as finance, accounting and operations.

The majority of advisers have little formal technology infrastructure in place to support their regulatory reporting activities. In reality, we have found that only a few of the very largest asset managers have the necessary staff, analytics and systems and repeatable and sound processes to do recurring regulatory reporting efficiently in-house.

Key recommendations

Below are four major recommendations for advisers to consider, to ensure that they are prepared to be in full compliance with all of the reporting requirements under the quarterly statements rule.

First, advisers should prepare early to either internally undertake this reporting or to outsource the data and reporting work to an experienced service provider that can do all of the necessary data aggregation and curation for sound regulatory reporting. Whether this work is done internally or by a service provider, advisers should begin at least two to three quarters in advance of the compliance date (14 March 2025) to develop a well-defined plan and perform testing.

Second, in the event that an adviser has the necessary infrastructure (e.g., data warehouse and analytics) to do regulatory reporting in a sound and repeatable manner, a data strategy and associated workflows will need to be developed as a key part of the plan to implement the new reporting under the prescribed quarterly deadlines.

Third, given the linkage between the customary investor reporting and the new quarterly statements rule, advisers should first focus on further improving and automating their existing process around their financial close that is done monthly and quarterly. In addition, the overall process for producing and distributing investor reporting should not be manual and spreadsheet driven but should largely be automated.

Lastly, many advisers may benefit from outsourcing and using a firm that takes a software as a service (SaaS) approach to data management, data curation and outsourced reporting for regulatory

reporting. This approach has the major advantage of bringing in expertise and 'bodies' to assist with the large amount of complex upfront work needed to implement and manage efficient processes for data aggregation, data normalisation, data enrichment and data transformation and curation.

A SaaS approach solution is optimal for most managers, as it can provide the needed new data and reporting infrastructure without substantial upfront and ongoing maintenance costs and without the need for reference data, analytics and dedicated staff. However, it should be noted that there are relatively few firms in this space thus far, and they are not all alike in terms of experience, technology and pedigree.

Conclusion

The quarterly statements rule represents a significant paradigm shift for regulatory reporting and compliance. It is part of a much larger secular trend toward more transparency and accountability with respect to the information and data that asset managers must provide to internal and external constituents. As such, asset managers would be wise to have a comprehensive strategy and overarching plan for all data and reporting that a fund must do, including investor reporting, risk management reporting and environmental, social and governance (ESG) reporting. R&C

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