Fund Finance Industry Avoids Biggest Impacts of SEC's Private Funds Rulemaking

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Introduction

On August 23, 2023, the Securities and Exchange Commission (the "***SEC***") adopted new rules under the Investment Advisers Act of 1940 that apply, in certain cases, only to registered private fund advisers and in others, to all private fund advisers (such adopted rules, collectively, the "***Final Rule***")[1]. The adoption of the Final Rule was a long time coming. More than 18 months earlier on February 9, 2022, under Chairperson Gary Gensler, the SEC published a historically sweeping proposal of rules to further regulate the private funds industry in a 342-page document including discussion, commentary, legal basis, questions for consideration, proposed rule text, economic analysis and alternative rules considered (the rules included in such earlier proposal, collectively, the "***Proposed Rule***").[2]

While the Proposed Rule produced hundreds of comment submissions from both investor and private fund trade associations, as well as other interested parties, and sought outright bans on commonly accepted business practices by private fund managers,[3] the SEC's adoption of the Final Rule last week brings relatively little disruption for the fund finance market. This is because the portions of the Final Rule that relate to or are tangential to fund finance have largely been adopted in the form articulated in the Proposed Rule, which, in our view, was never going to "chill" subscription financings, as had been suggested when the Proposed Rule was published.[4] While certain portions of the Final Rule relate to or are relevant to fund finance market participants, including new mandated investor disclosure of fund performance metrics *without impact of a subscription line*, the Final Rule in no way restricts the use of frequently-utilized fund finance products. This is certainly a favorable outcome for the fund finance industry, but the Final Rule does impose a host of new requirements and restrictions on the private funds industry that are unprecedented in scope and likely to present commercial challenges (i.e., with respect to side letters and other arrangements with "anchor" or strategically significant investor relationships vis a vis other investors) to a variety of fund sponsors, irrespective of asset class or platform scale.

In this article, we summarize the portions of the Final Rule we consider to be of interest to fund finance market participants. In doing so, we can't help but note that the most interesting thing about the Final Rule is that even though some version of a subscription financing (in its infancy) has existed since as early as 1987,[5] the Final Rule is the first instance we're aware of in which a regulatory body, via administrative rulemaking, has codified the concept of a "subscription facility"– perhaps the ultimate signal of a mature product or perhaps the size of the industry has grown to a point where it could no longer be

[1] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 6383 (Aug. 23, 2023), (hereinafter Final Rule) available here.
[2] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 5955 (Feb. 9, 2022), (hereinafter *Proposed Rule*) available here.
[3] Proposed Rule, at 132-161.
[4] Chris Cumming, *Proposed SEC Rule Could Chill Private Equity's Performance-Enhancing Borrowing*, The Wall Street Journal (Feb. 25, 2022), available here.
[5] Haynes and Boone data.

ignored by regulators? Either way, the adoption of the Final Rule was a significant event for fund finance market participants.

Borrowings

In its discussion about the Final Rule, the SEC acknowledged that private funds can assume various types of complicated structures and involve complex financing mechanisms. In regard to subscription financings specifically, the SEC stated that: "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 the ability to execute deals quickly and efficiently."[6]

Recognizing the benefits of such financings and consistent with its Proposed Rule, the SEC's Final Rule does not place any size (by reference to aggregate capital commitments, unfunded capital commitments or otherwise) or timing (how long draws may remain outstanding) limitations on subscription lines – such limitations at one time being advocated by the Institutional Limited Partners Association ("***ILPA***") as requirements that should be included in a fund's partnership agreement[7]. In fact, in the Final Rule, the SEC made clear that "the rules do not dictate or limit the ability of private funds to engage in excessive leverage or borrowing."[8] Notably, there are no restrictions on other fund-level indebtedness, such as NAV credit facilities. We consider the lack of restrictions on fund-level debt of any kind to be one of the most encouraging aspects of the Final Rule to the entire private funds ecosystem.

In fact, the only restriction on borrowings in the Final Rule is that Private Fund Advisers[9] and their related persons are prohibited from engaging in borrowings from a "private fund client" unless the Private Fund Adviser (i) distributes a written notice and description of the material terms of the borrowing to the investors of the applicable private fund, (ii) seeks the investors' consent for the borrowing, and (iii) obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the Private Fund Adviser[10]. In this context, "private fund client" refers to the actual private investment fund and not its underlying investors.[11] Thus, the rule imposes restrictions on borrowing arrangements whereby an adviser or one of its related persons borrows from one of the private investment funds that the adviser manages.[12] And, as some commentators have observed, this is not a widespread practice in the private funds industry, so the lack of any meaningful borrowing or fund-level leverage restrictions in the Final Rule is a big win for the private fund industry and the fund finance market.

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[6] Final Rule, at 130 n. 375.
[7] Institutional Limited Partners Association, Subscription Lines of Credit and Alignment of Interests, June 2017.
[8] Final Rule, at 36.
[9] A "***Private Fund Adviser***" is an investment adviser to a "private fund," which is an issuer of securities (e.g., limited partnership interests) that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act. *See* Form ADV, Glossary of Terms, at 34, available here.
[10] Final Rule, at 243–251 (to be codified at 17 C.F.R. § 275.211(h)(2)-1(a)(5)).
[11] *See* Final Rule, at 19 ("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)."
[12] The SEC does not interpret the restrictions on borrowings to apply to ordinary course tax advances when a fund provides an adviser or its affiliates an advance of money against the adviser's actual or expected future share of the fund's assets to allow the adviser or its affiliate to meet certain of its tax obligations (or its investment professionals' tax obligations) as they are due. 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. Per the SEC, 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. Final Rule, at 249.

Quarterly Statements

The SEC's real focus on fund finance – and specifically on subscription financings – is revealed in its Final Rule on mandated quarterly statements, as discussed in the performance subsection below. Consistent with the Proposed Rule, the newly adopted quarterly statement rule requires Private Fund Advisers that are registered with the SEC (or required to be registered) ("***RIAs***") to prepare a quarterly statement that includes certain information regarding fees, expenses, and performance for any private fund that it advises, and to distribute the quarterly statement to the private fund's investors[13] ("***Quarterly Statements***"). Quarterly Statements must be distributed within 45 days (or 75 days, for a fund of funds) after the end of each of the first three fiscal quarters of each fiscal year and 90 days (or 120 days, for a fund of funds) after the end of the fiscal year of the private fund. For newly-formed private funds, the Final Rule requires that Quarterly Statements be distributed upon the completion of the fund's second full quarter of generating operating results.[14] The Final Rule takes a principles-based consolidation approach and requires RIAs 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 (such as with master-feeder structures and with main funds and parallel funds).

Subscription lenders likely do not need to make any adjustments to their loan agreements in order to receive copies of Quarterly Statements of funds that are credit parties or other obligors under their financings, as most loan agreements require delivery to the lenders of copies of all reporting that the private investment fund or its managing entity distributes to the investors.

Changes from Proposed Rule

- The Final Rule provides more time for funds of funds based on commentary the SEC received indicating that funds of funds will need to receive reporting from their private fund investments before they are able to prepare their own quarterly statements.

- The Final Rule allows additional time for delivery of fourth quarter statements (the Proposed Rule required the fourth quarter statements to be delivered within 45 days of quarter end rather than the 90 days in the Final Rule).

- The Final Rule references *fiscal* periods, rather than *calendar* periods.

Quarterly Statements: Fee and Expense Disclosure

The Quarterly Statement must include, in table format, a "detailed accounting" of all fees and expenses allocated to or paid by the private fund 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) (such period, the "***Reporting Period***"). Advisers are not permitted to (i) group fund expenses or fees into broad categories but rather must list each category of expense as a separate line item, (ii) exclude de minimis expenses or (iii) label expenses as "miscellaneous." As examples of fees and expenses which must be included in the Quarterly Statement, the SEC lists organizational, accounting, legal, administration, audit, tax, due diligence, broken deal fees and travel expenses. As one of its justifications for adopting such a rule, the SEC states that "expenses have risen significantly in recent years for certain private funds due

[13] Private Fund Advisers are not required to prepare or distribute a Quarterly Statement if a statement that otherwise complies with the rule is prepared and distributed by another person. 17 CFR 275.211(h)(1)-2.
[14] Final Rule, at 146.

to, among other things, advisers' use of increasingly complex fund structures and increased service provider costs."[15]

Given the number and unique types of fees and expenses that private investment funds are frequently authorized to incur under their governing agreement (i.e., think about a standard definition of "Partnership Expense" in a fund's governing agreement), this portion of the Quarterly Statement could be quite lengthy and meticulous from the sponsor's perspective. With regard to disclosure of fees paid to lenders, agents and arrangers under a fund financing arrangement, ideally such fees could be aggregated under a heading of "financing fees" (as they are under GAAP) or something similar without running afoul of the restriction noted above in order to prevent confidential or commercially sensitive fee information for an agent, arranger or lender to be subsequently disclosed to other lenders party to the transaction (via the lenders' receipt of the Quarterly Statement). These types of questions will have to get sorted out in the coming months as RIAs begin preparation with counsel for compliance. As discussed above, most loan agreements for subscription facilities will require the RIAs to send copies of Quarterly Statements prepared in respect of fund-borrowers to lenders as part of standard subscription line reporting.

In some of its commentary about this portion of the Final Rule, the SEC did address confidentiality concerns that were raised in several comments it received, but in a different context – a concern about disclosure of the names of portfolio investments. The SEC largely dismissed this concern indicating that many investors will likely already know this information and that investors who receive such information via the new Quarterly Statement are typically subject to contractual confidentiality restrictions requiring them to maintain the confidentiality of such information. The same would be true regarding investors receiving sensitive fee information regarding the fund's financings.

Changes from Proposed Rule

- The Proposed Rule only captured amounts "paid by" by the private fund, but the Final Rule captures such amounts along with fees and expenses "allocated to" the private fund during the Reporting Period.

Quarterly Statements: Performance Metrics for Illiquid Funds

The Quarterly Statement rule also requires RIAs to illiquid funds (described in the Final Rule as "generally closed-end funds that do not offer periodic redemption/withdrawal options other than in exceptional circumstances, such as in response to regulatory events"[16]) to include standardized fund performance information in each Quarterly Statement. The Final Rule requires different performance information to be included in the Quarterly Statements for liquid funds, but since most of the in-scope private investment funds that have subscription financings will fall into the Final Rule's definition of "illiquid fund," this article focuses solely on Quarterly Statement requirements for illiquid funds.

The required performance information included in the Quarterly Statement must be based on gross and net internal rates of return ("***IRR***") and gross and net multiples of invested capital ("***MOIC***") since inception and must be computed *with* and *without* the impact of any fund-level subscription facilities. For performance measures *without* the impact of fund-level subscription facilities, the Final Rule requires

[15] Final Rule, at 86.
[16] Final Rule, at 114. The SEC acknowledges that withdrawal rights exist in closed-end private equity funds, for ERISA, Bank Holding Act and other extraordinary circumstances, such as violations of state pay-to-play laws, but nonetheless such private equity and similar closed-end funds would still be classified as illiquid funds under the Final Rule so long as such opportunities to redeem are limited. Final Rule, at 115.

advisers to calculate performance measures as if the private fund had called investor capital, rather than drawing down on fund-level subscription facilities.[17] Additionally, the SEC has stated that it interprets the phrase "without the impact of fund-level subscription facilities" to exclude fees and expenses associated with the subscription facility, such as interest expense, when calculating net performance figures. For performance metrics *with* the impact of fund-level subscription facilities, the Final Rule requires advisers to calculate such metrics reflecting the actual capital activity from both investors and fund-level subscription facilities, including any activity prior to investor capital contributions as a result of the fund drawing down on fund-level subscription facilities. The Proposed Rule only required that such metrics be reported *without* use of a subscription facility, but the SEC has stated that after reviewing comments received, "fund performance both with and without the impact of [subscription facilities] are necessary to enable investors to better understand how the use and cost of any [subscription facilities] are affecting their returns."[18]

In its commentary about this portion of the Final Rule, the SEC stated that it received comments requesting that advisers who use subscription financings on a short-term basis to manage capital (rather than to increase returns) be exempt from this portion of the Final Rule. The SEC acknowledged that use of subscription financings in this manner "may be less likely to cause the issues [the SEC is concerned about]," but that creating such an exemption could "lead to certain undesirable outcomes" noting that a fund may clean down subscription line draws early in its life cycle and thus would not have to report the unlevered performance measures but then start to leave such draws outstanding for longer spans of time for the remaining life of the fund, making it difficult for investors to assess the newly-received unlevered performance metrics when it had not been receiving them previously.[19]

The SEC has defined "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." The SEC explicitly acknowledged the value of subscription financings[20] but also noted that many RIAs are providing performance metrics reflecting the impact of such financings, and the SEC believes such levered performance figures "have the potential to mislead investors" given that subscription financings permit the fund to delay calling capital, which has the potential to increase performance metrics artificially. As additional justification for mandating such performance metrics, the SEC has stated that such standardized information will allow investors to make comparisons across funds managed by different RIAs. Notably, in commentary included in both the Proposed Rule and the Final Rule regarding transparency into the calculation of performance metrics, the SEC cites ILPA Principles 3.0, published by ILPA in 2019, which stated that "[d]uring fundraising and included in regular reporting over the life of the fund, LPs should be provided with performance information, i.e., IRR . . . MOIC figures, *with and without the use of* such [subscription] facilities in order to inform performance comparisons on a vintage year basis and relative to other funds."[21]

Additionally, the Final Rule requires RIAs to present a statement of contributions and distributions for illiquid funds that reflect the aggregate cash inflows from investors and the aggregate cash outflows from the fund to investors, along with the fund's net asset value. The SEC has instructed RIAs to consider including any fees and expenses related to a subscription facility in this statement. The SEC also noted that RIAs may wish to consider providing other details they believe investors will find relevant in the

[17] Final Rule, at 127.
[18] Final Rule, at 29.
[19] Final Rule, at 127-30.
[20] Final Rule, at 130.
[21] *See* Proposing Release, page 58 and Final Rule, page 68, in each case citing ILPA Principles 3.0 (2019).

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.

Changes from Proposed Rule

- The Proposed Rule only required RIAs to illiquid funds to calculate performance information *without* impact of subscription facilities. The Final Rule requires calculation of performance information *with and without* impact of subscription facilities.

- The Final Rule changed the definition of "illiquid fund" to be based primarily on withdrawal and redemption capability rather than the six factors articulated in the Proposed Rule (limited life, no continuous capital raise, not required to redeem interests upon request, does not routinely acquire as part of its investment strategy market-traded securities, limited opportunities for investors to withdraw, predominant strategy is the return of proceeds from investment dispositions).

Adviser-Led Secondaries / Continuation Fund Requirements

Citing inherent conflicts of interest present when the same party participates on both sides of a transaction, the SEC has been scrutinizing (and in its Final Rule has decided to regulate) RIAs who initiate an "adviser-led secondary transaction," which the SEC defines as a transaction that offers private 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 RIA or any of its related persons. Such additional vehicle is often referred to by market participants as a "Continuation Fund," and Continuation Funds have become increasingly popular in recent years as the market for private equity exits continues to be tepid, due to lower sale price multiples and the increasing cost of debt suppressing the ability of prospective purchasers to efficiently leverage new buyouts[22]. As part of the Final Rule, RIAs must obtain a fairness opinion *or* a valuation opinion from an independent third party and distribute such opinion to the private fund investors prior to the due date of the investor's election form.[23]

The SEC has described a fairness opinion as 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, and has described a valuation opinion as a written opinion stating the value (as a single amount or a range) of any assets being sold. The SEC has noted that RIAs and investors will have the ability to negotiate which opinion is more appropriate.

Additionally, RIAs of prospective Continuation Funds must prepare and distribute a written summary of any material business relationships between the adviser or its related persons and the independent opinion provider. Whether a business relationship is material requires a facts and circumstances analysis; however, the SEC notes that for purposes of this portion of the Final Rule, audit, consulting, capital raising, investment banking, and other similar services would typically meet this standard.[24]

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[22] Preeti Singh, *Investors See Both Promise and Risk in Continuation Funds*, The Wall Street Journal (Jan. 20, 2022), available here; *see also* Karen Schwartz, *In It for the Long Haul: Continuation Funds on the Rise*, Middle Market Growth (Mar. 7, 2023), available here.

[23] "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. 17 CFR 275.211(h)(1)-1.

[24] Final Rule, at 202.

Given the conflict of interest inherent in advising both the seller and the purchaser in connection with a Continuation Fund formation transaction and in light of the different investor bases capitalizing the funds involved in the transaction, sponsors have typically been cautious in effecting these transactions. Many were consulting limited partner advisory committees, forming a representative board, obtaining the approval of a majority of the selling fund's investors, obtaining a third-party valuation report or fairness opinion as to the transaction terms or a combination of the foregoing, so the actual operational burden attributable to the Final Rule should be minimal for many sponsors.

Lenders financing Continuation Funds should be aware of this new requirement and may start to see language regarding such opinions in governing documentation, subscription agreements and side letters (noting that some investors had already been requesting such opinions in connection with rolling existing interests into a Continuation Fund). Whether a lender to a Continuation Fund could receive a copy of the opinion as a diligence matter may depend on whether the opinion contains disclosure language preventing the fund from making such a disclosure – or whether the prospective lender enters into a non-reliance agreement with the opinion provider.

Changes from Proposed Rule

- The Proposed Rule required RIAs to obtain and distribute a fairness opinion. The Final Rule provides RIAs with the option of obtaining and distributing a fairness opinion *or* a valuation opinion.

- Both the opinion and the summary of material business relationships must be distributed prior to the *due date of the election/solicitation form* to investors instead of prior to *closing of the transaction*, as the Proposed Rule specified.

Preferential Rights and Preferential Information / Side Letters

The Final Rule includes a disclosure obligation on all Private Fund Advisers with respect to preferential rights given to an investor in a private fund. Such rights are typically given to investors in "side letter agreements" that have the effect of modifying a fund's governing agreement, but only with respect to the subject investor. The timing of such disclosure obligation is dictated by whether such preferential right relates to "material economic terms." If the Private Fund Adviser or any of its related persons has received preferential treatment related to "material economic terms," then it must provide to each *prospective* investor, prior to the investor's investment in the fund, a written notice specifying such preferential treatment.

From a practical perspective, if any preferential treatment is given relating to material economic terms, the Private Fund Adviser may elect to disseminate its side letter compendium prior to each private fund's investor closing (rather than waiting until after the final investor closing has concluded, as is customary with "most favored nations" elections), although there are lingering questions about the timing for delivery of information contained in side letters that are entered into at the same time.

Then, an adviser must provide written disclosure to investors of *all* preferential treatment the adviser or its related persons have granted to other investors in the same illiquid fund (regardless of whether such preferential treatment relates to "material economic terms"), as soon as reasonably practicable following the end of the fund's final closing. The SEC noted that it would be appropriate to distribute these notices within four weeks of an illiquid fund's final closing. Finally, there is an ongoing disclosure notice that

requires advisers, on at least an annual basis, to provide written notice to other investors if any investor has received any preferential treatment since the investors received the last written notice.

Additionally, the Final Rule, subject to certain exceptions, also includes restrictions on granting investors certain preferential redemption rights and providing information regarding portfolio holdings or exposures of the private fund or a 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 similar pool of assets. The SEC has noted that preferential information that has been provided to an investor in an illiquid fund generally would not be viewed as having a material, negative effect on other investors.

Rated Note Feeder Structures

In commentary related to the SEC's decision to exclude securitized asset funds from certain portions of the Final Rule, the SEC acknowledged that in recent years private funds have made modifications to their terms and structures to facilitate investment by insurance companies.[25] Further, the SEC noted that these funds are typically structured as "rated note funds" and often issue both equity and debt, rather than only equity interests, given such insurance companies' regulatory capital requirements. The SEC did not impose any limitations or restrictions on such structures, but the capital treatment for insurance companies for such structures remains under active discussion by the National Association of Insurance Commissioners as of August 2023.

Effectiveness and Compliance

The Final Rule is effective 60 days after the date of publication in the Federal Register but there are different compliance periods for different rules within the Final Rule, ranging from 60 days to 18 months. Some industry bodies who provided comments to the Proposed Rule suggested that the SEC did not have the necessary authority from Congress to promulgate such rules.[26] After reviewing such comments, the SEC went to great lengths in its commentary about the Final Rule to defend its position regarding its authority to adopt and implement such rules.[27] We will be monitoring whether any challenges are filed.

To view the Final Rule, click here: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf

For a more comprehensive discussion of the new rules and their implications under the Investment Advisers Act of 1940, please see the Haynes Boone Investment Management Alert published Aug. 30.

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[25] Final Rule, at 54.
[26] *Comment Letter of the Center for Capital Markets Competitiveness*, U.S. Chamber of Commerce (Apr. 25, 2022), available here; *Comment Letter of the Managed Funds Association*, Managed Funds Association (Apr. 25,2022), available here; *Comment Letter of American Investment Council*, American Investment Counsel (July 27, 2022), available here.
[27] Final Rule, at 32-45.