PRIVATE EQUITY PERFORMANCE IMPROVEMENT

Improving Fund Manager Operations: Increasing Regulatory Requirements

Alternative asset managers, in particular the private equity industry, face increasing operational challenges. These challenges include the new SEC regulatory changes, ever increasing LP demands, and increasing business complexity due to recent growth.

A&M is launching a new series focused on helping private equity managers improve their internal operations. This series aims to address pain points for managers and provide practical insights and solutions for alternative asset fund managers.

In this inaugural edition, we asked Private Equity Performance Improvement Managing Director and **head of our Fund Management Solutions** practice **John Scerbo** to weigh in on private equity regulatory changes stemming from the recently announced Private Fund Adviser rules release on August 23rd (see the SEC fact sheet here).

Q1 *Can you summarize the latest regulatory rule making and its impact for private equity managers?*

Trying to summarize a 660 page document is always tricky. However, I do think there is a theme to these new rules. In our view the theme is for investors to get more transparency, more documentation, and more disclosure. While the most recent rule changes certainly regulate manager activities, they also substantially increase requirements for managers to expand the frequency and nature of documentation, reporting and disclosure provided to investors across a number of topics.

Q2 *How do you expect to see the new reporting requirements impact managers?*

Managers now need to provide a tremendous amount of specific & detailed disclosure regarding returns, fees and expenses in the quarterly data provided to investors. The rules are quite prescriptive in describing the timing & detail of the reporting managers owe to investors. The quarterly reporting includes IRR & MOIC disclosures with disaggregation by realized vs unrealized performance, as well as gross and net performance disclosures. Managers will also need to produce quarterly a reconciliation of all revenues received by a manager and its affiliates from the fund and its investments, including items like monitoring and transaction fees, with reconciliation & disclosure of any carry forward balances for items that are management fee offsets. We think there could be substantial effort to track and document all fees & expenses paid by portfolio companies to the manager and affiliates. As one example, the rules would seem to include disclosure of items like Operating Partner compensation which may not have been historically tracked for fund reporting.

There is also much greater granularity required in the disclosure of fund expenses as managers need to detail expenses by category including regulatory, compliance, audit, and other categories separately and more specifically. The SEC has flagged eleven different expense types for disaggregation and is no longer allowing advisers to exclude de minimis expenses, or generally group small expenses into broad categories via the use of “miscellaneous” or “other expense” categories.

In addition to the substantial increase in the content of what needs to be reported, the timelines for reporting are no longer just a requirement of a fund's Limited Partner Agreement: they are being mandated by the SEC as due within 45 days for each quarter and 90 days at year end. We expect that between the increased contentand new more stringent deadlines, this may require a substantial evolution for many managers in their investor reporting.

Q3 *That's meaningful, but you also mentioned there are increased disclosure requirements. What do those look like?*

Another key area for additional and proactive disclosure is manager-led secondaries, which includes continuation funds. As continuation funds (and other manager-led secondaries) have proliferated, we expect many if not most managers to be impacted. When undertaking a continuation fund or other secondary transaction, managers will need to obtain either a third-party valuation report or a fairness opinion. That information must be disclosed to investors in advance of obtaining their commitments for any transaction. This is of course, in addition to the Form PF disclosure rule for these transactions that the SEC introduced for managers earlier this year.

Beyond secondaries, managers will also need to provide advance & ongoing written notice regarding preferential economic terms offered to other investors via side letters. This is a new requirement, and one that needs to be incorporated into what is already a more challenging fundraising environment.

Q4 *You mentioned it wasn't just about disclosure. So what are some of the key requirements for managers beyond disclosure?*

The new rules will end the ability to offer investors preferential disclosure or liquidity provisions. Fortunately for most private equity managers (in contrast to hedge fund managers) preferential liquidity is not a material consideration given private equity fund structures.

Managers will also need to build a more robust compliance process that requires them to conduct an annual compliance review and document that effort in writing. For some managers this may just be about increased record keeping and disclosure. We suspect for other managers, however, this may cause them to institute a more robust and consistent compliance function. As an additional overlay to these updates to compliance regulations, new disclosure and notice requirements have been introduced regarding compliance expenses that managers plan to charge to a fund.

Q5 *How long will managers have to respond to these new rules?*

According to the new guidance, managers with $1.5B or more in assets under management need to implement the bulk of these changes within the next 12 months. For managers with less than $1.5B under management they have an additional 6 months, so 18 months in total. The reporting requirements become effective in 18 months regardless of a manager's size. Lastly, the compliance rules we just discussed kick in upon a managers compliance review that occurs after Oct 22, 2023.

Also, as with any rule-making of this scale (the rules are enshrined in a 660 page document which can be found here) there will likely be updated guidance from the SEC; and of course the advice of manager's legal and regulatory advisors will be important. We think this timeline is appropriate given the breadth of the changes and updates, and the degree of effort involved for many managers to update their finance & compliance functions to comply with the new standards.

Q6 *Is there any final takeaway you have regarding the new rules?*

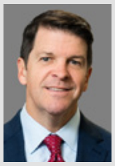
We would expect investors to begin asking managers about where they stand regarding the new rules. Managers need to develop a strategy for the rules now and provide clear communication of that strategy to investors. Investor communication is always critical, and it is especially true here given how central investor disclosure updates are to the rule changes. As managers develop their comprehensive response to the regulations, clear and consistent investor communication about how managers are responding is critical.

CONTACT US

Learn more about how we can help you with Increasing Regulatory Requirements

John Scerbo
Managing Director

jscerbo@alvarezandmarsal.com
+1 646 495 3600



David Richards
Senior Director

drichards@alvarezandmarsal.com
+1 732 533 8395

Companies, investors, and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 8,000 people providing services across six continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

Follow A&M on:

To learn more, visit: **AlvarezandMarsal.com**

ALVAREZ & MARSAL
LEADERSHIP. ACTION. RESULTS.℠