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# Managing Private Funds in a Volatile Market: Interacting With Investors, Lenders, and Regulators

Investments, Distributions, Governance, Conflicts, Fund Finance Concerns

THURSDAY, MAY 26, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:


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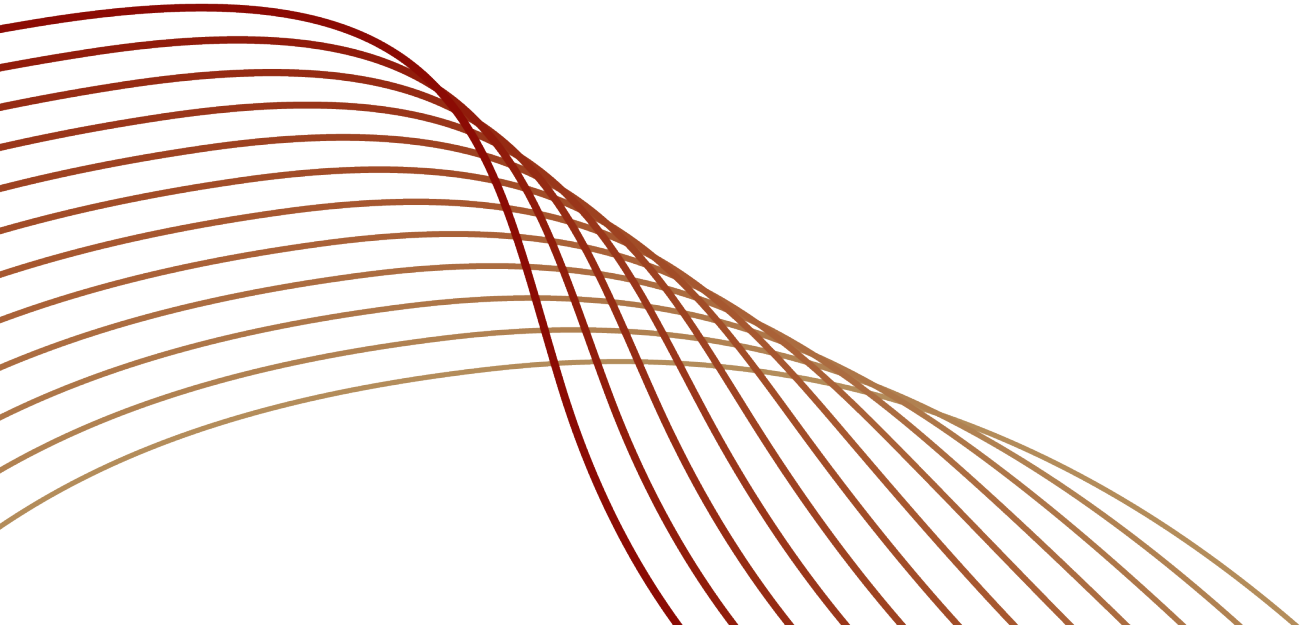
# MANAGING PRIVATE FUNDS IN A VOLATILE MARKET

May 2022



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# PRESENTERS



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# UPDATE ON U.S. REGULATORY ISSUES FOR PRIVATE FUND MANAGERS

- The SEC's recent Risk Alert and other areas of enforcement focus for private fund managers during 2022
- The SEC's proposed updates to Advisers Act rules

# THE SEC'S JANUARY 2022 RISK ALERT



- The SEC's recent Risk Alert and other areas of enforcement focus for private fund managers during 2022

A. Fiduciary duties
B. Conduct inconsistent with disclosures
C. Disclosures regarding prior performance and marketing
D. Due diligence
E. Hedge clauses

# RECENT SEC RISK ALERTS



- Recent SEC Risk Alerts highlight the SEC's observations of common deficiencies from its examinations of private fund advisers
- Risk alerts should be viewed as guidance to provide advisers with the opportunity to review and remedy issues with improved compliance programs before facing any regulatory or enforcement issues
- Themes of recent risk alerts are similar:
  - Gaps in client and investor disclosures regarding conflicts of interest
  - Deficiencies in disclosures related to fees and expenses (and related issues)
  - Issues with policies and procedures related to the treatment of material nonpublic information (MNPI)

# CONFLICTS OF INTEREST DISCLOSURES



- Allocation of investment opportunities
- Conflicting client investments
- Economic relationships
- Preferential liquidity rights
- Principal investments
- Co-investments
- Service providers
- Fund restructurings
- Cross-transactions

***Consider requirements under Section 206 of the Investment Advisers Act of 1940 and Advisers Act Rule 206(4)-8.***

***Err on the side of specificity and ensure that affiliated service providers follow disclosures.***

***The risk alerts do not assert that any of the conflicts of interest on this list are inconsistent with or violative of an adviser's fiduciary duty or otherwise in violation of any rule*

# FEES AND EXPENSES DEFICIENCIES



- Improperly splitting fees among fund investors
- Overcharging or failing to properly reimburse investors for fees and expenses
- Expense disclosures that are too general or imprecise to constitute informed consent by investors
- Impermissible expenses in violation of a fund's organizational documents
- Insufficient disclosures regarding the role of and compensation provided to "operating partners"
- Allocation, disclosure, and monitoring of portfolio company fees

*Compare compliance policies with fund governing documents and Form ADV disclosures to ensure consistency.*

*Regular reviews should be conducted regarding the allocation of expenses with periodic tests by compliance personnel.*

*Fund governing documents should clearly set forth expenses allocated to the fund.*

*Internal policies should set forth a procedure to remediate any violations.*

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# MNPI POLICIES



*Policies and procedures should address:*

- **Insider trading risks posed by employees interacting with people with access to MNPI, such as public company insiders, consultants retained through "expert networks" and "value-added investors"**
- **Risks related to general employee access to MNPI**
- **Restricted trading lists with specificity**
- **Employees' receipt of gifts from third parties**

***Section 204A of the Advisers Act requires that advisers establish and maintain written policies and procedures that prevent misuse of MNPI.***

***Code of Ethics Rule 204A-1 obligates advisers to establish standards of conduct for advisory personnel and to resolve conflicts raised by their personal trading.***

# MNPI POLICIES



- Review internal policies and procedures to ensure that they are sufficiently specific and extend, as applicable, to directors, officers, employees, consultants, and other outside professionals;
- Revise internal policies and procedures as necessary to ensure that the definition of "confidential information" includes not only "company information" but also "government decisions";
- Evaluate relationships with government entities and carefully assessing whether any information obtained from those relationships is nonpublic and/or pre-decision information that could create insider trading liability if traded on;
- Regularly assess the effectiveness of internal controls, making modifications as appropriate;
- Temporarily impose blackout periods for trading or enhancing pre-clearance procedures during times of crises;
- Provide written guidance to all officers, directors, and employees that emphasizes the importance of their obligations to keep material nonpublic information that they may have access to confidential; and
- Continue regular compliance training via video conferencing or other means to address the specific risks posed by the COVID-19 pandemic and the expected increased scrutiny on trading.

# PROPOSED ADVISERS ACT RULE CHANGES



- Potential new rules and compliance requirements:

1. Standardized reporting requirements
2. Performance data
3. Certain prohibited activities
4. Preferential treatment/side letters
5. Fairness opinions for adviser-led secondary transactions
6. Documentation of annual compliance review
7. Audited financial statements

- Proposed changes to Form PF

# PROPOSED ADVISERS ACT RULE CHANGES



1. Standardized reporting requirements

Proposed Rules would require private fund advisers to prepare and distribute quarterly statements to investors within 45 days after each calendar quarter end using a standardized format.

These statements would be delivered in addition to (or as part of) any other reporting requirements negotiated by investors in the fund.

These statements would require disclosure of all fees, payments, compensation, and expenses paid to the adviser and related persons (a defined term in the Proposed Rules).

Would include a separate “Portfolio Investment Table”.

# PROPOSED ADVISERS ACT RULE CHANGES

2. Performance data

Proposed Rules would also require delivery of quarterly statements that include standardized performance-related metrics, using uniform definitions for performance metrics like internal rate of return ("IRR") and multiple of invested capital ("MOIC").

- Gross and net IRR for the full fund since inception,
- Gross and net MOIC for the full fund since inception,
- Gross IRR and gross MOIC shown separately for the realized and unrealized portions of the fund's portfolio,
- A statement of the fund's aggregate contributions and distributions,
- A statement of the fund's net asset value, and
- The criteria and assumptions used in calculating performance.

# PROPOSED ADVISERS ACT RULE CHANGES



3. Certain prohibited activities

Proposed Rules also prohibit specific activity and transactions:

- Charging certain fees to portfolio companies such as monitoring, servicing, consulting fees or other fees where actual services are not provided.
- Charging for fees or expenses associated with an examination or investigation of the adviser by any governmental or regulatory authority (regardless of whether such examination or investigation uncovers any questionable or troubling conduct).
- Charging the fund for any regulatory or compliance fees or expenses of the adviser or its related persons.
- Seeking reimbursement, indemnification, exculpation, or limitation of liability from a private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, recklessness, or, importantly, negligence. (Most funds operate with a “gross” negligence standard.)
- Allocating fees and expenses related to a portfolio investment (or proposed portfolio investment) on a non-pro rata basis when multiple private funds and other clients of the adviser have invested (or proposed to invest).

# PROPOSED ADVISERS ACT RULE CHANGES

4. Preferential treatment/side letters

The Proposed Rules would prohibit private fund advisers from directly or indirectly providing:

- Preferential terms to certain investors regarding withdrawals/redemptions or information about portfolio holdings or exposures if the adviser reasonably expects that doing so will have a material, negative effect on other investors in the fund, or

- Any other preferential treatment to any investor in the fund unless the adviser provides written notice regarding the preferential treatment to (1) prospective investors before they invest in the fund, and (2) current investors on an annual basis.

# PROPOSED ADVISERS ACT RULE CHANGES

5. Fairness opinions for adviser-led secondary transactions

Adviser-led secondary transactions are an increasing trend in the private fund market and occur when a private fund adviser initiates a transaction whereby private fund investors are provided the option of liquidating their interests in the fund (and/or a particular portfolio investment or group of portfolio investments) or converting those interests into interests in a new investment vehicle advised by the adviser on new terms, typically with an extended holding period for the underlying investment(s).

The Proposed Rules prohibit these types of transactions unless the adviser distributes a fairness opinion from an independent valuation firm to fund investors before the transaction closes (along with a written summary of any material business relationships the private fund adviser or any of its related persons has had in the past two years with the independent opinion provider).

# PROPOSED ADVISERS ACT RULE CHANGES

6. Documentation of annual compliance review

Currently, the Advisers Act requires registered investment advisers to review their compliance program annually.

Under the Proposed Rules, registered investment advisers would also be required to document this annual review in writing.

# PROPOSED ADVISERS ACT RULE CHANGES

7. Audited financial statements

The Proposed Rules would require registered private fund advisers to obtain from an independent public accountant an annual audit of the financial statements of all of its managed or advised funds.

This requirement would apply regardless of the manner in which the adviser satisfies the Advisers Act Custody Rule with respect to its managed or advised funds.

# PROPOSED ADVISERS ACT RULE CHANGES



- Proposed changes to Form PF

The proposed changes to Form PF would:

- Require certain large hedge fund advisers to file reports on Form PF within one business day of certain reporting events, including certain extraordinary investment losses, significant margin and counterparty default events, material changes in prime broker relationships, changes in unencumbered cash, operations events, and events associated with withdrawals/redemptions,

- Require advisers to certain private equity funds to file reports within one business day of certain reporting events, including execution of adviser-led secondary transactions, implementation of general partner or limited partner clawbacks, removal of a fund's general partner, termination of a fund's investment period, or termination of a fund,

- Reduce the reporting threshold for large private equity advisers from $2 billion to $1.5 billion and require additional disclosure on fund strategies, use of leverage, and certain portfolio-level information, and

- Require large liquidity fund advisers to report information similar to that included in Form N-MFP required of money market funds.

# PRIVATE FUNDS AS BORROWERS AND LENDERS



***Headwinds to Watch*** (Ukraine, Inflation, US Labor Market, Supply Chain Disruption and COVID-19)

***Private Funds as Borrower/Sponsor – What to do?***

- Options for Liability Management Exercises for Portfolio Companies
  - NAV or other financial covenant issues in fund finance facilities
  - Takeaways

***Private Funds as Lenders – What to do?***

- Take stock of portfolio and potential issues related to possible LME transactions
- Organize with other like-minded lenders
- Be aware of potential issues with warehouse facilities, TRS or other fund-level financing facilities (NAV, secured value coverage, etc.).
- Takeaways

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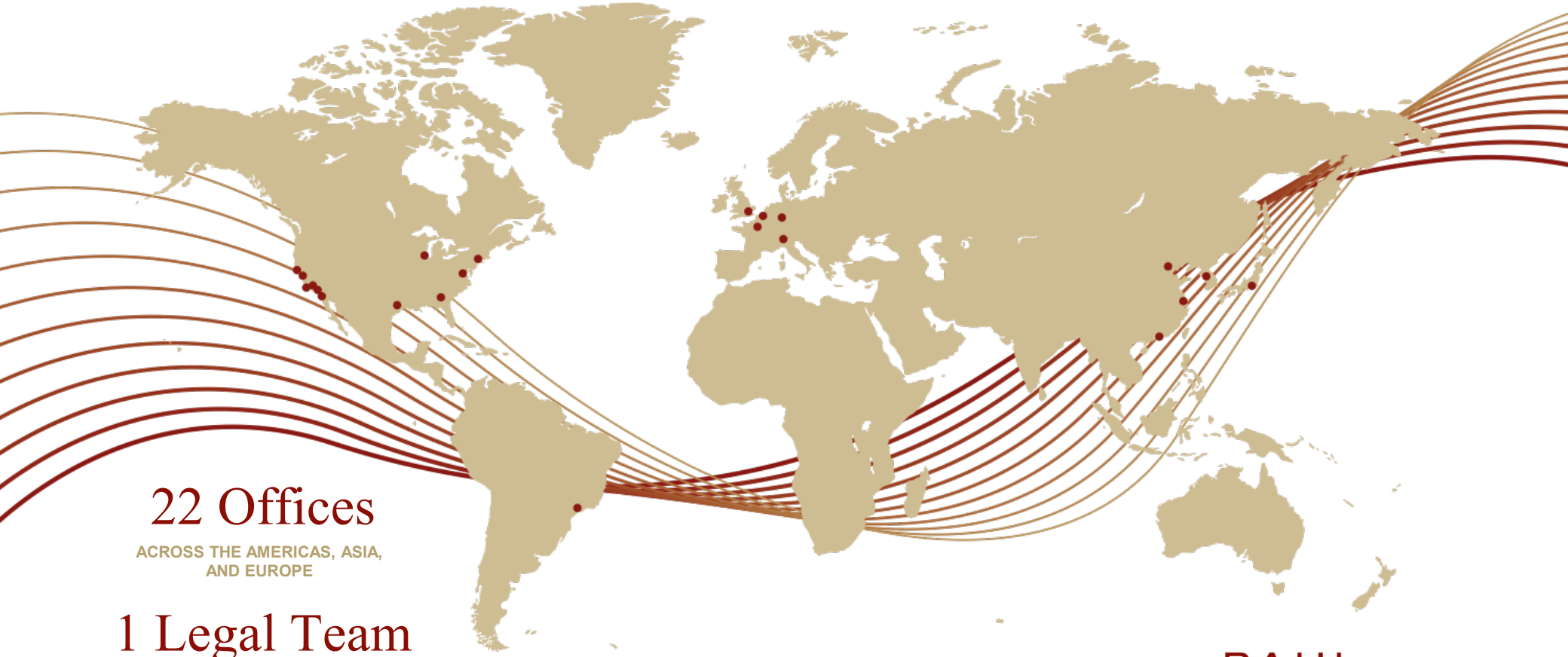

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TO INTEGRATE WITH THE STRATEGIC GOALS OF YOUR BUSINESS

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# Thank You

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