New in RegTech:

Private Fund Adviser Reforms, EU Due Diligence Directive, & Form PF Changes

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Fly on the wall: with compliance dates approaching, industry roundtable meets on SEC's Private Fund Adviser Reforms

With summer already around the corner, that gone-too-soon season is now the only thing separating fund advisers from a major compliance date under the SEC's Private Fund Adviser Reforms. As we covered in our November 2023 edition, 14 September 2024 is when large private find advisers must start adhering to new rules for adviser-led secondary transactions, restricted activities and preferential treatment. The SEC's reforms set forth these dates for compliance:

Date	Requirement
13 November 2023	Amended Advisers Act compliance
14 September 2024	Advisers with ≥ $1.5 billion private fund AUM: • Advisor-led secondaries • Restricted activities • Preferential treatment
14 March 2025	Advisers with < $1.5 billion private fund AUM: • Advisor-led secondaries • Restricted activities • Preferential treatment Quarterly statements Audit rule

During a balmy couple of days befitting of summer's fast approach, on May 7th and 8th Confluence held industry roundtable events, in Boston and New York, that revealed the top challenges faced by fund advisers and administrators in their efforts to comply with the upcoming requirements. Here we'll look at feedback produced at the New York session.

Quarterly reporting

Notwithstanding the nearby 14 September 2024 date on which several of the Rule's obligations kick in, it was in fact the quarterly reporting, starting from 14 March 2025, that brought the most discussion out of the seasoned compliance and operations managers in attendance. Indeed challenges abound with respect to the detailed quarterly information, that the SEC is requiring advisers to send to investors, about each private fund's fees and expenses, compensation and performance.

Fees and expenses must be broken out by category, and before and after offsets, waivers or rebates, and with tables at the portfolio as well as the fund level. Performance for liquid funds will require disclosure of net annual total returns for the 10 prior fiscal years, as well as averages for the prior 1-, 5- and 10-year periods, and cumulatively through the end of the most recent quarter. Performance for illiquid funds, meanwhile, must be parsed in a number of ways including by net and gross IRR (internal rate of return) as well as MOIC (multiple on invested capital), realized and unrealized gains, with and without subscription facilities.

Several in attendance thus endorsed a strong focus on data delivery and workflow. And yet their concern about a lack of data was felt keenly (notably with respect to realized versus unrealized gains). Finding some of the historical information is proving challenging for many advisers, especially when obstacles arise such as a change in fund administrator. The importance of a robust gap analysis, and then disclosing methodologies within the quarterly report, were favorably stressed.

In many areas, attendees noted difficulties in interpreting particular SEC requirements. (For example the quarterly statement's consolidated report, required for "similar pools of assets" which can be subject to interpretation. While it was observed that the SEC may take a broad view of that term, it was also expressed that in edge cases, breaking out the reporting could be more advisable for reasons of clarity.) The moderator -- a funds attorney and law firm partner with deep expertise in the field – acknowledged the Rule's frequent recourse to undefined "facts and circumstances" that could decide issues. (Interestingly, he added that these hard-to-define areas of the Rule could in fact be among the most important for the SEC.)

If firms are not sufficiently prepared, such challenges will be compounded by the reporting deadline: 45 days after each fiscal quarter-end and 90 days after each fiscal year-end. (But for fund of funds, 75 and 120 days respectively.) Many at the table recognized the challenge, but are not yet able to target particular hurdles until their new workflows are put in place. "We need to build the report first, then we'll have an idea", said one large fund administrator.

Additional requirements

The Rule's requirements for adviser-led secondaries, preferential treatment and restricted activities were discussed as well, particularly in light of the fast-approaching compliance date of 14 September 2024. Again here, regulatory uncertainty attracted particular interest. For the preferential treatment disclosure, for example, how should side letters be presented? It was suggested that reporting parties can submit side letters in redacted form (if there are a limited number of them), or else simply produce a list of side letters with a summary of the rights granted by each letter (if there are many side letters to disclose). And what if a fund is liquidating; would side letters still be considered preferential treatment? While this would be "facts and circumstances"-dependent, the moderator explained that the issue could well hinge on whether the rights granted in the side letter could still be exercised. Is there still a client relationship among the parties? These were but a small portion of the many nuanced issues covered.

Pending litigation

The group also touched on the industry's pending lawsuit, that currently sits before a 3-judge panel of the Fifth Circuit Court of Appeals. (See our analysis in the February 2024 edition.) It was noted that we should not expect much guidance from the SEC until the case is resolved. (Meanwhile a high-level overview of the Rule is set forth in the SEC's Small Entity Compliance Guide for private fund advisers).

The court's decision is expected at the end of May 2024, but it's under no obligation to stick to that timeframe. While the Rule's aspects on preferential treatment and restricted activities appear to be most under threat, it's possible that the quarterly disclosure requirement, or even perhaps the entire Rule, gets overturned. Moreover the losing party -- whether the SEC or industry groups -- may well file an appeal (to the full slate of Fifth Circuit judges "en banc", or else to the Supreme Court), which could end up delaying application of the Rule.

And yet, roundtable attendees were virtually unanimous in their view that operational readiness currently takes priority. Several noted, moreover, that most investors strongly welcome the SEC-mandated information. (The investor trade body ILPA , supportive of the Rule, has established working groups and is updating its template for the new quarterly reporting.) In other words, a competitive advantage will rest with advisers and administrators that can provide the detailed quarterly reports and related disclosures to their clients, regardless of the regulatory landscape.

Author - Greg Hotaling, Regulatory Content Manager at Confluence

> ***"[I]nvestors are free to request and negotiate for, disclosure of additional information to supplement the standardized baseline level (i.e., the mandatory floor) of fund-level fee and expense, adviser compensation and performance disclosure required in the quarterly statements…"***
> *SEC, Private Fund Advisers – A Small Entity Compliance Guide*

Due Diligence Directive: landmark EU law requiring sustainability reaches final step

As we detailed back in in 2022, the next big step in ESG regulation for companies and financial firms goes beyond disclosure, requiring policies that actively embrace sustainability. The EU's flagship regulation here is the Corporate Sustainability Due Diligence Directive (CSDDD, or CS3D).

For the past two years CS3D has undergone major changes in its journey across EU institutions. This has frustrated European lawmakers such as Member of Parliament (and SC3D Rapporteur) Lara Wolters, who cited "backstabbing" and "posturing" by certain members of the European Council (which demanded significant concessions at a very late stage, even after having agreed to a provisional deal in December 2023). It was reported that support from Germany, France and Italy, among other countries represented on the Council, had eroded suddenly.

Hence, some stakeholders are calling the resulting version of CS3D, recently approved by the European Parliament on 24 April 2024, a watered-down act that doesn't go far enough.

With its reduced number of companies in scope -- those with at least 1,000 employees and €450 million net worldwide turnover (for EU companies) or else simply €450 million net EU turnover (for non-EU companies) -- today's CS3D is estimated to cover only 30% of the companies it had initially targeted. (Certain franchisors are in scope too, if they have at least €80 million net turnover and €22.5 million in royalties.)

Moreover the “chain of activities”, which companies must consider in their sustainability obligations, appears narrower than the “value chain” originally envisaged. Both terms consider a company’s (with its contracted firms) upstream (such as development, materials sourcing) and downstream (such as transport, storage) impacts on sustainability. But in a “chain of activity”, as defined in the revised CS3D, downstream effects exclude the provision of services.

“Regulated financial undertakings”, to the extent they are covered by CS3D and meet the financial thresholds, are broadly defined to include AIFMs (but not AIFs), MiFID investment firms, credit institutions, UCITS management companies (but not UCITS), insurance companies, CSDs, crypto firms and more. But for such financial companies, the current CS3D specifies that “only the upstream but not the downstream part of their chains of activities should be covered by this Directive”. (CS3D also calls for a reconsideration of the issue at a later date: within two years the European Commission must submit a report on possible additional requirements for regulated financial undertakings.)

The titular “due diligence” required by CS3D comprises a wide-ranging set of obligations. Due diligence is defined as “risk-based human rights and environmental due diligence as laid down in Articles 7 to 16” of CS3D. Companies must ensure that they are:

“(a) **integrating due diligence into their policies and risk management systems** in accordance with Article 7;

(b) **identifying and assessing actual or potential adverse impacts** in accordance with Article 8 and, where necessary, prioritising actual and potential adverse impacts in accordance with Article 9;

(c) **preventing and mitigating potential adverse impacts, and bringing actual adverse impacts to an end** and minimising their extent in accordance with Articles 10 and 11;

(d) **providing remediation for actual adverse impacts** in accordance with Article 12;

(e) **carrying out meaningful engagement with stakeholders** in accordance with Article 13;

(f) establishing and **maintaining a notification mechanism and a complaints procedure** in accordance with Article 14;

(g) **monitoring the effectiveness of their due diligence** policy and measures in accordance with Article 15;

(h) **publicly communicating on due diligence** in accordance with Article 16.”

CS3D, Art. 5 (emphases added)

CS3D also requires companies to adopt a climate change transition plan, compatible with the Paris Agreement goal of limiting global warming to 1.5°C, with quantifiable targets for 2030 and subsequent 5-year increments up to 2050.

Thus companies finding themselves within the scope of CS3D will need to go far beyond their practices of sustainability disclosure (e.g. per CSRD and SFDR), and launch new workflows for sustainable policies and actions. They must do so according to these compliance dates, depending on the size of the company:

3 years after entry into force (likely 2027)

- EU companies with >5,000 employees and >€1.5 billion net worldwide turnover
- Non-EU companies with >€1.5 billion net EU turnover.

4 years after entry into force (likely 2028)

- EU companies with >3,000 employees and >€900 million net worldwide turnover
- Non-EU companies with >€900 million net EU turnover.

5 years after entry into force (likely 2029)

- EU companies with >1,000 employees and >€450 million net worldwide turnover
- EU franchisors with >€80 million net worldwide turnover and >€22.5 million in worldwide franchise royalties
- Non-EU companies with >€450 million net EU turnover
- Non-EU franchisors with >€80 million net EU turnover and >€22.5 million in EU franchise royalties

It should be noted that the financial thresholds are also applied on an aggregate basis, across a group, for ultimate parent companies which can thereby be brought in-scope under CS3D. (The parent company can apply for an exemption from this consolidation requirement, needing to meet certain conditions.)

CS3D must now be endorsed by the European Council, after which it will be published in the Official Journal and go into effect 20 days later. This is expected in June 2024 or thereabouts, according to most observers (but based on the recent drama, one can never be sure). Then, EU Member States will have two years to implement CS3D into their national laws.

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> ***"This really is a landmark today. I am so proud that the EU can stand tall in the world, and say that we are doing our bit to make sure there are no more products on the market that come at the cost of human lives and environmental destruction "***
> *Lara Wolters, Member of European Parliament, Rapporteur for CS3D.*

Form PF reporting: private fund advisers confront another round of changes

Private fund advisers that file Form PF, the confidential disclosure created in 2011 under the Dodd-Frank Act, will again be adjusting their compliance processes as a result of the SEC's and CFTC's latest round of amendments adopted on 8 February 2024. Following two sets of changes adopted in 2023 (mentioned in our November and December issues), which covered Sections 3, 4, 5 and 6 of the Form, the agencies have now amended requirements under Sections 1 and 2 as well as the General Instructions. The compliance date for this latest set of changes is 12 March 2025.

Citing the need to further manage systemic risk, by requiring more data for analysis by the Financial Stability Oversight Council (also created under Dodd-Frank), the SEC and CFTC are imposing upon advisers enhanced reporting of investment, borrowing and counterparty exposures, separate reporting for feeder funds and parallel fund structures, more required data about the adviser itself, and further changes.

The SEC's Fact Sheet summarizes the amendments. The Rule itself details the new requirements, attaches the revised Form PF (as Appendix A on page 272), and provides a table marking out the latest amendments as well as the filing deadlines for different types of advisers (page 242). At a high level, the revised Form is organized as follows:

Section 1a: Information about you and your related persons

Section 1b: Information about the private funds you advise

Section 1c: Information about the hedge funds you advise

Section 2: Information about qualifying hedge funds that you advise

Section 3: Information about the liquidity funds that you advise

Section 4: Information about private equity funds that you advise

Section 5: Current report for large hedge fund advisers to qualifying hedge funds

Section 6: Quarterly report for advisers to private equity funds

Section 7: Request for temporary hardship exemption

For a detailed dive into how these Form PF changes will affect reporting scenarios and impact compliance processes, see our recent webinar "Unpacking the SEC's Amendments to Form PF: Sections 1 and 2" as well as our separate breakdown in this RegTech Report edition.

And for more information about how the SEC uses Form PF data, see its recent Annual Report to Congress on the topic. There, the SEC also attaches its latest quarterly report "Private Fund Statistics", a 66-page analysis based on data collected from Form PF and Form ADV filings.

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> ***"The value of private fund net assets reported on Form PF has more than doubled, growing from $5 trillion (net) in 2013 to $14 trillion (net) through the first quarter of 2023."***
> *SEC, Introduction to Rule, "Form PF; Reporting Requirements for All Filers and Large Hedge Fund Advisers.*

Form PF Sections 1 & 2 Breakdown: what's changing for what filers?

CHANGES FOR ALL FILERS

Fund of fund reporting

- Investments in other funds must be considered for all reporting thresholds and form responses
- Individual reporting of investments to/from internal private fund

Fund structures

- Separate reporting of parallel fund structures and many feeder funds
- Trading Vehicles: Identification of trading vehicles; look-through reporting of investment exposure through vehicles; segregated reporting of counterparty exposure

More monthly data for quarterly filers

- NAV/GAV, unfunded commitments, subs/reds Fund performance
- IRR may be reported in lieu of gross/net returns
- New reporting of return volatility

CHANGES FOR ALL HEDGE FUND ADVISERS

Counterparty exposure

- Fund-by-fund reporting of aggregate counterparty exposures and collateral
- Identification of the exposed entity (i.e., the fund or a trading vehicle) for individual counterparty exposures
- Dollar values of borrowings, exposure, collateral Trading and clearing mechanisms
- Adjusted mechanism categories
- Dollar value of trades now required, instead of a percentage breakdown
- End-of-period value of positions acquired through each mechanism Section 2a removed
- Aggregate reporting of hedge funds no longer required

CHANGES FOR QHFs (QUALIFYING HEDGE FUNDS):

Investment exposure

- Updated sub-asset class categories
- Must break down by instrument type (e.g. physical, derivative, indirect)
- New adjusted exposure, netting across underlying reference asset/maturity bucket Portfolio concentrations
- New breakouts of large currency, industry, and country concentrations
- Security-by-security reporting of large individual exposures Counterparty exposure
- Aggregated information about borrowings, derivative positions, collateral, and credit exposures consolidated into a single table
- Separate reporting of borrowing and lending in each category
- 1% margin increase impact assessments
- Similar breakouts required individually for each of the 5 largest individual creditors and debtors
- Identification of the exposed entity (i.e., the fund or a trading vehicle) for individual counterparty exposures
- Additional individual exposure reporting related to cleared exposures

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