Milbank

Insights

Structured Credit Practice

SEC Adopts Final Private Fund Rules with Carveout for “Securitized Asset Funds”

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On August 23, 2023, the Securities and Exchange Commission (the **SEC** or the **Commission**) voted 3-2 to adopt a suite of new and amended rules (the **Final Rules** or the **Private Fund Rules**) applicable to investment advisers that advise private funds.[1] Following a 12- to 18-month transition period,[2] the new rules will restrict advisers from engaging in certain practices that, in the Commission’s view, have the potential to harm private fund investors and will require, among other things, that advisers obtain annual private fund audits and provide private fund investors with detailed quarterly information on fund performance, expenses, and adviser compensation.[3]

While far-reaching,[4] the new rules are significantly scaled back from the version first proposed by the Commission in February 2022 (the **Proposed Rules**),[5] which met with vigorous industry resistance and

[1] *See* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance, SEC Release No. IA-6383 (Aug. 23, 2023) (the “**Adopting Release**”), and the accompanying Fact Sheet. The Private Fund Rules comprise five rules, including: the audit and quarterly statements rules (Rules 206(4)-10 and 211(h)(1)-2, respectively); the restricted activities rule (Rule 211(h)(2)-1) (restricting certain practices generally involving expense allocations and borrowing from private funds); the adviser-led secondaries rule (Rule 211(h)(2)-2) (generally requiring that advisers obtain independent fairness opinions in transactions where they require investors to choose between selling and exchanging their private fund interests); and the preferential treatment rule (Rule 211(h)(2)-3) (restricting advisers from providing preferential treatment (e.g. under side letters) as to liquidity or access to information and requiring them to disclose other material preferential terms to all investors).

[2] For the audit and quarterly statements rules, compliance becomes mandatory 18 months following the publication of the rules in the Federal Register. For the other Private Fund Rules, compliance becomes mandatory 12 months (for advisers with $1.5 billion or more in private fund assets under management) or 18 months (for other advisers) after the publication date.

[3] The Adopting Release also amends the investment adviser compliance rule, Rule 206(4)-7 under the Advisers Act, to require that all RIAs (whether or not they advise private funds) document the annual review of their compliance policies and procedures in writing. This requirement becomes mandatory 60 days after the date of publication in the Federal Register.

[4] A lawsuit filed with the U.S. Court of Appeals for the Fifth Circuit by six industry trade groups challenges the adoption of the Final Rules as an abuse of the SEC’s discretion and an excess of its statutory authority. Nat’l Ass’n of Private Fund Mgrs. et al. v. Securities and Exchange Commission, No. 23-60471 (5th Cir. filed Sept. 1, 2023).

[5] SEC Release No. IA-5955 (Feb. 9, 2022).

advocacy. In response, the Commission included key mitigations in the Final Rules, including a broad exemption for "securitized asset funds" (**SAFs**), defined to include "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders." The SAF exemption will generally exclude collateral managers from the Private Fund Rules as they would otherwise apply in respect of collateralized loan obligations (**CLOs**) and similar vehicles. Below, we consider the elements of the SAF exemption and related issues of potential relevance to collateral managers.

What securitizations are in scope of the Private Fund Rules?

As a threshold matter, an issuer is potentially in scope of the Final Rules if it is a "private fund," defined in the Investment Advisers Act of 1940 (the **Advisers Act**) as an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (the **Investment Company Act**), but for Section 3(c)(1) or 3(c)(7) of that Act. Vehicles that rely on other Investment Company Act exceptions – such as the Section 3(c)(5)(C) "REIT" exception for funds that hold qualifying mortgages – are not "private funds" within the meaning of the Advisers Act, and the Final Rules do not generally apply to investment advisers to such vehicles acting in such capacity.[6]

CLOs most commonly rely on the Section 3(c)(7) exception under the Investment Company Act and therefore are typically "private funds." However, most CLOs are in effect excluded from the "private fund" definition for purposes of the Final Rules by virtue of the SAF exemption.[7]

"Securitized asset fund" exemption

Commenters on the Proposed Rules had argued that CLOs and other private funds that issue asset backed securities are fundamentally different from other private funds in ways that cause the Final Rules to be largely inappropriate or unnecessary. The Commission agreed and, noting that the "securitized asset fund" definition already in use in Form ADV and Form PF[8] – "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders" – captures the core characteristics that differentiate these vehicles and warrant their exemption,[9] chose to re-use that definition to carve such funds out of the Final Rules. Breaking down the elements of the definition:

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[6] As an exception and caveat – certain exempt reporting advisers, in order to qualify for exemption from full registration under the Advisers Act, may elect to treat certain funds they advise as "private funds" even though the funds do not rely on Section 3(c)(1) or 3(c)(7). *See* Rule 203(m)-1(d)(5) (on the private fund adviser exemption) and the note at the end of Rule 203(l)-1 (defining "venture capital fund" for purposes of the venture capital fund adviser exemption). Advisers that do so must treat such funds as "private funds" for *all* Advisers Act purposes and will therefore be subject to the Final Rules (or those portions that apply to unregistered investment advisers) with respect to such funds.

[7] The SEC notes, however, that it will "continue to consider whether any additional regulatory action may be necessary with respect to SAF advisers in the future." Adopting Release at 54 n.154.

[8] Form ADV (Schedule D, Section 7.B.(1)10) requires advisers of private funds to check a box indicating private fund "type" (securitized asset fund, private equity fund, etc., with corresponding definitions in Instruction 6 to Form ADV Part 1A). Form PF (Section 1a Item B) requires advisers to provide a breakdown of their private fund AUM by fund type based on the same set of categories and definitions (included in the Form PF Glossary of Terms).

[9] The relevant distinguishing features of SAFs cited by the Commission include that:

(1) SAF investors are primarily interested in information and metrics they can use to measure the likelihood that they will receive the agreed-upon return on their debt investments, whereas the types of information required to be furnished under the Private Fund Rules – e.g., quarterly statements including fund-level rates of return, expenses, and adviser compensation and annual audited GAAP financial statements – have little value or relevance to most SAF investors;

(2) In most cases, such relevant information is already required to be provided to SAF investors in detailed quarterly and monthly reports prepared by a fund trustee or administrator;

(3) Because SAF notes are typically held in street name and traded in the secondary market, SAF advisers generally lack the necessary investor contact information to satisfy the delivery requirements under the Final Rules; and

"Asset backed securities"

A private fund must issue *asset backed securities* to qualify as a SAF. The Final Rules do not define "asset backed securities" for this purpose;[10] presumably, a private fund satisfies this element if it issues "asset backed securities" within the meaning of the Securities Exchange Act of 1934 (**Exchange Act ABS**),[11] as do most CLOs and other securitizations.

However, some private securitizations issue notes that are not Exchange Act ABS – for example, because the securitized assets are not self-liquidating. May an adviser nonetheless treat such a securitization as an exempt SAF under the Final Rules? The Adopting Release does not address this question. Given the different policies underlying the Final Rules and the Exchange Act ABS rules, however, advisers might reasonably conclude that they may treat a securitization as an issuer of asset backed securities for purposes of the SAF definition if it has the characteristics cited by the SEC as the rationale for the SAF exemption.[12]

"Primary purpose"

The issuance of asset backed securities must be the *primary purpose* of a private fund that qualifies as a SAF. Although "primary purpose" as used in the Final Rules is also not defined, the standard should allow flexibility for funds to qualify as SAFs even if they do not have asset backed securities outstanding at all times. A CLO in the warehousing stage, for example, typically does not yet issue asset backed securities but should meet the primary purpose element because it is organized and operated in order to do so.

On the other hand, depending on the facts and circumstances, a private fund that invests in loans and incurs leverage strategically to enhance returns to its equity investors may not qualify as a SAF, in the Commission's view, even if the fund's capital structure consists primarily of debt.[13]

"Investors are primarily debt holders"

For a fund to qualify as a SAF, its investors must consist *primarily* of *debt holders*. The Commission cautions that "debt holders," in its view, do not include investors that hold notes or are referred to in fund documents as debt investors but have "equity-investor rights (e.g., no right to repayment following an event of default)."[14] Elsewhere in the Adopting Release, the Commission describes debt interests of SAFs as interests that are structured to provide defined returns based on defined levels of risk, in contrast to SAF equity interests, which are structured to provide variable investment returns.[15]

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(4) SAFs pose less risk of investors' requesting, and advisers' granting, preferential treatment, because investors are primarily debt holders that are similarly situated with, and cannot redeem ahead of, the other noteholders in the same tranche.

See Adopting Release at 57-60, 400-01, 434.

[10] Nor does Form ADV. The Form PF Glossary of Terms does include a definition of the acronym "ABS" – "[s]ecurities derived from the pooling and repackaging of cash flow producing financial assets" – although the term is used only in reference to fund portfolio investments.

[11] Private fund securitizations would not generally be issuers of asset backed securities under the other common federal securities definition, in Regulation AB, which applies only to issuers that are subject to Exchange Act reporting and disclosure requirements.

[12] *See* footnote 9 above.

[13] *See* Adopting Release at 56 n.159 ("private credit funds that borrow from third party lenders to enhance performance with fund-level leverage and invest in underlying loans alongside the equity investors [would not meet the SAF definition], even if they borrow an amount greater than the value of the equity interests they issue").

[14] Adopting Release at 54 n.156.

[15] *See* Adopting Release at 400, 434-35.

Subordinated notes that represent the economic equity of a securitization would not generally constitute "debt" based on the above descriptions. Most CLOs should nonetheless satisfy the "primarily debt holders" element with little difficulty, given that equity tranches typically represent only a small portion of the capital structure.

Primarily in this context is not defined; in the context of the Investment Company Act, where interpretations are often consistent with those under the Advisers Act, the SEC has said that a threshold of 55% generally constitutes "primarily."[16]

* * *

Although the SAF definition in the Final Rules is the same as in the Form ADV instructions, the Commission notes that not all funds reported as SAFs in Form ADV will meet the SAF definition in the Final Rules. As an example, the Commission cites certain rated note funds and similar vehicles that are structured to facilitate insurance company investors' compliance with capital requirements under insurance regulation.[17] The release does not address the inverse question – whether an adviser may treat a fund as a SAF for purposes of the Final Rules if it is not so designated in Form ADV. To the extent there is ambiguity as to which fund type – SAF or a different category – best fits a given private fund, advisers should bear in mind that checking a non-SAF box in Form ADV may call into question whether they may treat the fund as a SAF for purposes of the Final Rules.

Apart from SAFs, are any other private funds out of scope of the Final Rules?

Generally, no. The Adopting Release emphasizes that an adviser that advises both SAFs and other private funds is fully subject to the Final Rules with respect to all non-SAF private funds it advises.

However, "offshore" advisers – advisers whose principal office and place of business is outside the United States – will effectively be exempt from the Final Rules in respect of non-U.S. private funds they advise, based on the Commission's historical position that the "substantive provisions" of the Advisers Act do not generally apply to offshore advisers in their relationships with non-U.S. clients. The Commission reaffirms this position in the Adopting Release (as in other recent Advisers Act rulemaking)[18] and states that the Final Rules are "substantive provisions" that do not apply to offshore advisers, whether registered or unregistered, in respect of their non-U.S. clients. The Adopting Release also reaffirms that a non-U.S. fund is a "non-U.S. client" for purposes of this approach, regardless of whether the fund has U.S. investors.[19]

As caveats to the above:

- The Commission's position on offshore advisers does not apply to offshore advisers that are "relying advisers," registered under umbrella registration on a single Form ADV with an affiliated filing adviser. Under the conditions to use of umbrella registration, the filing adviser must be a U.S.-based ("onshore") adviser and each relying adviser, regardless of where it or its clients are located, must comply with all of substantive provisions of the Advisers Act and the rules thereunder to the same extent as if the relying adviser's principal office and place of business were in the United States.[20]

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[16] E.g., SEC Release IC-17682 (Aug. 17, 1990) at n.33.

[17] Adopting Release at 426 n.1307.

[18] *See, e.g.,* the releases proposing the safeguarding rule (SEC Release IA-6240 (Feb. 15, 2023) at n.3) and adopting the revised marketing rule (SEC Release IA-5653 (Dec. 22, 2020), text preceding n.199).

[19] Adopting Release at 46-47.

[20] Form ADV: General Instructions, Instruction 5.ii.V.

- An offshore adviser that advises a non-U.S. fund but delegates some functions to a U.S.-based sub-adviser may wish to consider whether the involvement of an onshore adviser has implications on the applicability of the Final Rules (as well as other substantive Advisers Act requirements). Such situations would generally need to be analyzed case-by-case.

Finally, we note that a private fund that has no investment adviser is in effect out of scope of the Final Rules.[21] The caveat here is that, as with Advisers Act compliance in general, an adviser may not generally "structure around" the Final Rules by avoiding a direct relationship with a vehicle that the adviser is deemed to advise indirectly. Portions of the Final Rules explicitly apply to RIAs that advise a private fund "directly or indirectly,"[22] and the comprehensive anti-evasion provision in Section 208(d) of the Advisers Act prohibits any person from doing indirectly what it would not be permitted to do directly under the Advisers Act and the rules thereunder.

Beyond the Private Fund Rules

Thanks in large part to extensive advocacy on the part of industry groups and the SEC staff's willingness to engage with them, the Adopting Release represents perhaps the clearest official recognition to date that rules designed for typical private funds are often inappropriate as applied to CLOs and other SAFs. The distinguishing SAF features identified in the release – for example, that SAF securities are normally offered in capital markets transactions, traded in the secondary market by qualified institutional buyers, and held in street name;[23] that audited financial statements under GAAP offer limited benefit to, and may actually be confusing to, debt investors in cash flow vehicles;[24] and that performance and expense metrics for a fund as a whole have little or no informative use to investors that receive fixed payments under a waterfall [25] – have implications that go beyond the Private Fund Rules but have largely been overlooked in recent Advisers Act rulemaking.[26] It remains to be seen whether the staff's deepened understanding and apparent openness to engaging with representatives of the industry may pave the way for a more rational approach in applying Advisers Act rules to SAFs going forward.

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[21] Because the "private fund" definition is broad, it captures some issuers that are not conventional funds (such as certain static structuring vehicles and non-fund "inadvertent investment companies") and would not ordinarily have an investment adviser.

[22] The private fund audit and quarterly statement provisions of the Final Rules (Rules 206(4)-10 and 211(h)(1)-2) apply to RIAs with respect to each private fund they advise "directly or indirectly."

[23] *See* Adopting Release at 59.

[24] *See* Adopting Release at 404-05, 520.

[25] *See* Adopting Release at 447.

[26] For example, certain elements of the amended investment adviser marketing rule (Rule 206(4)-1) (e.g., regarding third-party solicitations of fund investors and presentations of fund performance information) are difficult to sensibly apply to the marketing of structured debt securities to institutional investors in capital markets transactions. Similarly, the proposed Safeguarding Rule issued in February 2023 (SEC Rel. IA-6240 (Feb. 15, 2023)) would impose requirements that do not appear to account for the operational features of private funds that do not fall within the typical hedge fund or private equity fund model. Concurrently with the release of the Private Fund Rules, the Commission reopened the comment period for the proposed Safeguarding Rule, in order to allow commenters additional time to assess the interplay with the audit provisions of the Private Fund Rules. The extended comment period ends October 30, 2023.

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