Global Research
& Risk Solutions

Opening the doors wider

New SEC rules set to reshape private markets

Analytical contacts:

Abhik Pal
Senior Director and Global Head of ESG & Research Practice
CRISIL GR&RS
abhik.pal@crisil.com

Pradeep Rajwani
Fixed Income Lead - Buy Side Practice
CRISIL GR&RS
pradeep.rajwani@crisil.com

The private asset management industry has experienced remarkable growth since the Global Financial Crisis, capitalizing on heightened regulatory scrutiny faced by traditional providers of capital, mainly banks and capital markets. In contrast, private asset managers have largely operated within a comparatively unregulated landscape. However, this landscape is on the verge of transformation with the forthcoming adoption of the Securities and Exchange Commission (SEC) rules aimed at enhancing transparency, accountability, and fairness in the private fund industry. This significant development is poised to exert a profound impact on private fund advisers, reshaping the fee structure and redefining operational practices.

SEC unveils sweeping rule changes

The new rules will come into effect by end-October 2023, with staggered implementation allowed based on fund size. The rules encompass five primary obligations, comprising three affirmative duties and two explicit restrictions

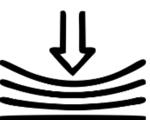
Obligations	Restrictions
1. Quarterly statements on the full cost and performance of private funds 2. Annual financial statement audits 3. Fairness or valuation opinion from an independent opinion provider for general partner (GP)-led secondary transactions	4. Engaging in restricted activities with the private fund 5. Giving preferential treatment to certain private fund investors without disclosing material terms to all investors

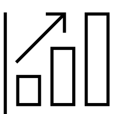
The regulatory journey that has led to the new rules has been neither new nor unexpected. A discussion paper on these rules had been in the public domain since February 2022, and the final rules (implemented on August 23, 2023) represent a somewhat softened version of the original proposal. Specifically, the "prohibited activities rule" has transformed into a "restricted activities rule," with several previously prohibited actions now permitted, contingent upon full investor disclosure. The final rules introduce a limited "legacy" or grandfathering status for current private fund clients, specifically pertaining to the redemption and information components of the Preferential Treatment Rule.

Industry reset ahead

As a result of this new regulation, we've identified three industry trends that are poised to redefine the landscape for private fund managers in the years ahead. These challenges encompass distinct areas where asset managers are expected to grapple with evolving regulatory requirements

Fee compression will accelerate | #2 **Increase in costs** | **Valuation practices set for reset**





1: Fee compression will accelerate

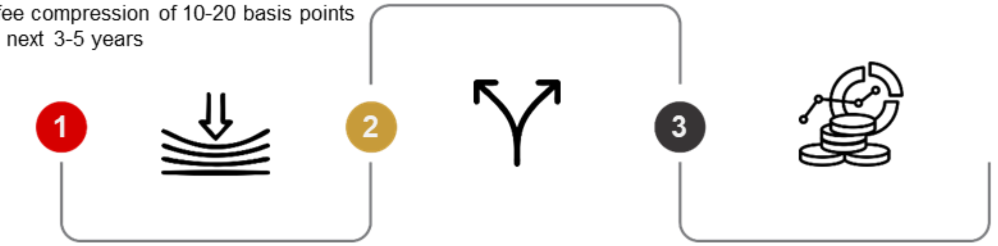
The private equity industry, traditionally characterized by its 2-20 fee model, is expected to undergo significant changes due to new regulations. Previously, often, large institutional investors negotiated personalized fees through confidential side letters, while smaller investors remained uninformed. These negotiations allowed them to secure fee reductions, co-investment rights, and "most favored nation" clauses, effectively customizing their fee arrangements to their advantage. As the industry adapts to the new transparency rules, we anticipate the following:

Downward pressure on fees

- SEC rules to bring "secret arrangements" to light, exerting downward pressure on fees
- GPs obligated to disclose preferential treatment to all LPs
- Expect fee compression of 10-20 basis points over the next 3-5 years

Pricing headwinds in distribution

- Anticipate pricing challenges within the private wealth distribution sector,
- Wealth has historically been a stable and dependable source of financial support



Divergence in fees likely

- Top-performing GPs may not be compelled to reduce fees, as robust fund performance continues to attract interest from LPs
- Others may struggle to negotiate favorable terms

Notably, the rules provide for ‘legacy status’ or ‘grandfather’ side letter agreements and other provisions that necessitate amendments to fund agreements, ensuring a nuanced transition within the industry.

2: Increase in costs

Compliance with the new rules is expected to increase costs for asset managers. The SEC-registered private fund advisers are now mandated to deliver standardized quarterly statements to investors, with comprehensive details on fund performance, fees, and expenses, within specific timeframes. Additionally, they must secure annual audits for each private fund, conducted by an independent auditor registered with the Public Company Accounting Oversight Board.

Here are the key aspects related to the increase in costs:

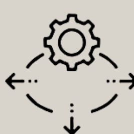
1. **Reporting burden to increase cost base by 3-5%**
    - The collective costs of fulfilling both audit and quarterly statement requirements are expected to reach $5.6 billion annually for the industry (Source: SEC)
    - This amounts to 3-5% of the total cost base of asset managers depending on their size with smaller firms seeing higher increase than the players with large scale.

2. **Mid-sized/smaller firms more exposed to margin impact in the near term**
    - Large firms have proactively enhanced their investor reporting practices, with some of these costs already absorbed
    - Mid-sized and smaller players are lagging in these investments, leading to an immediate impact on their profitability in the short term

3. **Cost reduction would be a key focus**
    - Asset managers to explore alternative avenues for cost reduction to balance compliance with financial returns
    - Anticipate a return to normalized earnings levels in the future helped by cost initiatives

3: Valuation practices set for reset

The regulations introduce a crucial mandate on fairness or valuation opinions for GP-led secondary transactions. These transactions, often initiated by advisors or related entities, present investors with the opportunity to sell or convert their interests in a private fund. While they offer advantages such as increased liquidity and potentially enhanced asset value, they raise potential conflicts of interest. To overcome this hurdle, the SEC rule requires advisors to obtain an independent opinion, ensuring fair dealing in such scenarios. The requirement safeguards against conflicts of interest, aligning with the overarching goal of enhancing transparency and bolstering investor confidence. We expect a reset of valuation practices in light of these regulations:



1. **LPs to demand robust valuation practices**
    - LPs seeking an exit through secondary transactions to push for making independent valuation opinions a best practice industry-wide.

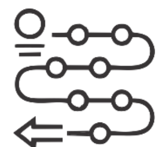
2. **Accurate valuation to gain emphasis**
    - Engaging third-party valuation experts and adopting rigorous practices to ensure accurate assessments

3. **Greater independence in valuation workflows**
    - Independent teams to oversee fair value through independent assessments or third-party providers.

In conclusion, the regulatory changes in GP-led secondary transactions and valuation opinions are reshaping the private fund industry. These changes not only ensure fairness and transparency but also underscore the significance of accurate valuation, especially in illiquid assets. As LPs assertively demand rigorous valuation practices, the adoption of independent valuation opinions is set to become a universal best practice across private funds. This transformative shift fundamentally alters how the industry approaches valuation and conflicts of interest, signaling a new era of accountability and integrity.

Is the industry prepared?

The private asset management industry has been actively anticipating and preparing for the introduction of new regulatory rules. However, the degree of readiness within this industry varies significantly based on the size of asset management firms.

	 Stage of adoption	Depth of implementation	Impact on profitability
Large firms	High	Comprehensive	Low
Mid-sized firms	Moderate	Partial	Moderate
Small firms	Limited	Minimal	Moderate

Larger firms with private assets under management (AUM) exceeding $50 billion have demonstrated a notably advanced state of readiness. These industry giants have proactively allocated substantial resources to meet compliance demands. They have invested significantly in the development of centralized data management platforms, which are specifically tailored to efficiently handle the reporting and portfolio surveillance requirements imposed by the new regulatory rules.

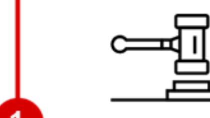
Additionally, larger firms excel in the area of fair value assessment for illiquid investments. They often adopt a comprehensive approach, combining internal fair value assessments with third-party independent validation services. This two-pronged strategy not only enhances the credibility and accuracy of their valuation processes but also seamlessly aligns with regulatory requirements.

On the other hand, **mid-sized firms** (with AUM ranging from $10 billion to $50 billion) and **small players** (with AUM below $10 billion) are still in the process of catching up. They face a more challenging journey toward compliance due to resource constraints and a relatively small operational scale.

These resource limitations may put them at a relative disadvantage in effectively managing the evolving regulatory landscape. They often rely more heavily on internal valuations, which, while cost-effective, may expose them to heightened scrutiny in an increasingly regulated environment.

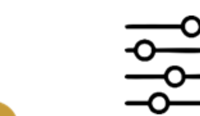
Next steps

Private asset managers are bracing for imminent SEC regulations focusing on transparency and compliance, which will impact fees, reporting, valuations, and compliance standards. Our guide provides best practices and a strategic roadmap for firms of all sizes, ensuring not only compliance but also success in this new regulatory era. The key steps include:



1 **Enhance compliance and reporting infrastructure**

- Establish a dedicated compliance team
- Invest in advanced reporting technology
- Consider outsourcing compliance functions if necessary



2 **Adjust fee structures and embrace valuation practices**

- Stay competitive by analyzing and adjusting fee structures
- Implement advanced valuation methods
- Explore cost-effective solutions for accurate valuation

3 **Leverage technology and third-party services**

- Invest in technology solutions
- Collaborate with experienced third-party providers specializing in compliance, reporting, and valuation services
- Stay connected with industry networks for insights and best practices

Looking ahead, the SEC's regulatory efforts aim to fill information gaps in privately held assets and democratize access. Asset managers with scale, diverse offerings, and a varied investor base are better positioned to meet increasing regulatory demands, thrive, and adapt in this era of heightened scrutiny.

About Global Research & Risk Solutions

CRISIL GR&RS is a leading provider of high-end research, risk and analytics services. We are the world's largest provider of equity and fixed-income research support to banks and buy-side firms. We are also the foremost provider of end-to-end risk and analytics services that include quantitative support, front and middle office support, and regulatory and business process change management support to trading, risk management, regulatory and CFO functions at world's leading financial institutions. We also provide extensive support to banks in financial crime and compliance analytics. We are leaders in research support, and risk and analytics support, providing it to more than 75 global banks, 50 buy-side firms covering hedge funds, private equity, and asset management firms. Our research support enables coverage of over 3,300 stocks and 3,400 corporates and financial institutions globally. We support more than 15 bank holding companies in their regulatory requirements and submissions. We operate from 7 research centers in Argentina, China, India, and Poland, and across several time zones and languages.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions with a strong track record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers through businesses that operate from India, the United States (US), the United Kingdom (UK), Argentina, Poland, China, Hong Kong, Singapore, Australia, Switzerland, Japan and the United Arab Emirates (UAE).

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

CRISIL Privacy Notice

CRISIL respects your privacy. We may use your personal information, such as your name, location, contact number and email id to fulfil your request, service your account and to provide you with additional information from CRISIL. For further information on CRISIL's privacy policy please visit www.crisil.com/privacy.

Argentina | Australia | China | Hong Kong | India | Japan | Poland | Singapore | Switzerland | UAE | UK | USA
CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com