Morgan Lewis

REPORT

PRIVATE FUNDS 2023
THE YEAR IN BRIEF

February 2024

www.morganlewis.com

© 2024 Morgan Lewis | Morgan, Lewis & Bockius LLP, a Pennsylvania limited liability partnership

PRIVATE FUNDS 2023: THE YEAR IN BRIEF

2023 was a watershed year for the private fund industry, not only because the US Securities and Exchange Commission (SEC) adopted a package of new regulations that will substantially alter the private fund landscape (subject to pending litigation), but also as a result of significant court decisions and other legislative developments. These developments took place against the backdrop of an increasingly globalized market that saw growing investor demand for everything from private credit to cryptocurrencies—all in evermore customized products and structures.

Meanwhile, various states enacted a variety of new laws that made for a continuously moving target of new disclosure requirements and regulations to employment and corporate practices. Here is a quick lookback at last year's important legal developments that affected the private fund space. Click on the embedded links for a more detailed description of these various items.

SEC Adopts Sweeping New Private Fund Adviser Rules

In August, the SEC adopted rules significantly affecting private funds advisers that, unless overturned or otherwise limited by the Fifth Circuit, will:

- limit the ability of a fund adviser to provide an investor with preferential liquidity or access to a fund portfolio's holdings or investment exposure, and impose notice requirements with respect to the provision of any preferential terms to an investor (including, but not limited to, material economic terms);
- restrict a fund adviser from participating in certain fund expense allocation practices, using clawback structures, or borrowing from the funds it manages;
- require distribution to fund investors of detailed quarterly statements of fund-level performance and expenses;
- require funds to undertake annual, independent audits (to the extent they do not do so already);
- require independent valuation opinions or fairness opinions in adviser-led secondary transactions;
- mandate that advisers memorialize, in writing, their annual compliance program review; and
- impose certain recordkeeping obligations in relation to these new practices and requirements.

The details (and potential pitfalls) of these new rules are extensive, and their application to various private fund adviser business models is far from intuitive. Accordingly, private fund advisers should expect to spend substantial time and resources in 2024 preparing for compliance. However, some advisers may decide to hold back from undertaking a fully accelerated process aimed at compliance, pending the result of the industry-led litigation.

Compliance dates for the new requirements will be as early as September 2024 for some private fund advisers. Meanwhile, institutional investors will continue to assess how these rule changes may alter their ability to negotiate bespoke terms or impact their access to fund information.

Proposed Amendments to CFTC Regulation 4.7

In October 2023, the US Commodity Futures Trading Commission (CFTC) proposed rules that, if adopted, will affect fund advisers that rely on CFTC Regulation 4.7. These proposed rules would update the definition of a "qualified eligible person," add minimum disclosure requirements and permit monthly account statements for fund-of-funds to be delivered within 45 days instead of 30 days. Currently, for funds that invest more than a minimal amount in commodity interests (which includes certain futures and swaps, among other instruments), Regulation 4.7 provides an exemption from onerous disclosure

requirements that would otherwise apply. Should these proposed changes move forward, fund advisers will become subject to new annual disclosure requirements for funds that rely on Regulation 4.7 at a cost that some argue would outweigh investor benefit.

Significant Increase in Beneficial Ownership Reporting

Nearly three years after its federal enactment, the Financial Crimes Enforcement Network (FinCEN) Corporate Transparency Act went into effect as the calendar turned to 2024, meaning that, absent certain limited exemptions, partnerships, LLCs, and other legal entities formed or registered under the laws of any US state must begin reporting their beneficial owners to FinCEN. These rules will affect many entities within fund and fund manager structures. Certain states, including New York and California, are at various stages of passing or proposing similar rules.

SEC Amends Form PF to Expand Disclosures

In May, the SEC enhanced the frequency and nature of reporting required of registered investment advisers of hedge funds and private equity funds on Form PF. These new requirements will create operational and compliance challenges for advisers, particularly for large hedge fund advisers, as certain "triggering events" must be reported within 72 hours. These "triggering events" include:

- Losses of 20% or more of a fund's aggregate value;
- Certain margin call defaults and margin increases;
- Certain counterparty defaults;
- Prime broker terminations and material restrictions;
- Significant disruptions to a fund's critical operations (for example, disruptions to the investment, trading, valuation, reporting, or risk management functions on which the fund relies);
- Redemptions in excess of 50% of a fund's net asset value; or
- Suspension of redemptions or inability to meet redemption requests.

The new requirements also impose significant reporting for registered investment advisers to private equity funds, including in relation to adviser-led secondary transactions, general partner removals and terminations of a fund or its investment period or the implementation of a carried interest clawback.

Current reporting for large hedge fund advisers and quarterly reporting for all private equity fund advisers was December 11, 2023, and the compliance date for the other sections is June 11, 2024. Meanwhile, in February 2024 the SEC already adopted still more changes to Form PF, which will be required at some point during the first half of 2025.

SEC Proposes Amendments to the Custody Rule

In February, the SEC proposed amendments that would overhaul the Custody Rule. As proposed, redesignated Rule 223-1 would reach a wider set of advisory activities and assets, expand recordkeeping requirements, and impose new conditions on custodial arrangements for client assets. Although many practitioners believe that, in some ways, the private fund industry might benefit from a clearer rule regarding the safekeeping of client assets (particularly in the wake of guidance published in 2017), the full impact of any rule changes will depend on the version of the rule that is adopted. The timeline of a final rule is uncertain, but because this proposal seems less controversial than certain other rulemaking efforts at the SEC, it seems likely that we will see a final rule at some point in 2024.

US Tax Court Decision on Self-Employment Tax Limited Partner Exception

On November 28, the US Tax Court held that state law limited partners in a private fund management entity organized as a Delaware limited partnership could not avoid the imposition of self-employment taxes under the "limited partner exception" set forth in the Self-Employed Contributions Act tax statute on their distributive share of partnership allocations of ordinary income.

This decision has the potential for far-reaching impact on the amount of self-employment income claimed by limited partners in a limited partnership structure (both historically and in the future) and the use of such structures, particularly those where participation in the profits of the fund manager by its limited partners is built into the firm's business model. Firms operating in this industry will now have to do a "functional analysis" test, which was left undefined by the court, to determine whether a partner is actually a "limited partner" for self-employment tax purposes. This conclusion may not resolve the issue with finality as the decision may be appealed.

US Tax Court Decision Clarifies Requirements for Profits Interest Grants

In a May 2023 decision, the US Tax Court clarified the requirements under IRS Revenue Procedure 93-27 (Rev. Proc.) for treating a profits interest grant as non-taxable to the grantee in a tiered structure when issued in exchange for providing services to, or for the benefit of, a partnership. When structured in accordance with the Rev. Proc., the grant of a profits interest is generally not a taxable event to the grantee.

In contrast, a capital interest granted in exchange for services gives the grantee a right to a share of the partnership's equity as of the grant date, and thus, a share of the proceeds upon liquidation. Such a capital interest grant is taxable to the grantee as compensation under the Rev. Proc. The case highlights the attention that should be paid to proper drafting of the operating agreements of any fund sponsor entities that grant profits interests in exchange for services.

US Tax Court Holds That a Non-US Fund Was Engaged in US Trade or Business via the Activities of Its Investment Manager

In its November 2023 decision, the US Tax Court concluded that the activities of a US-based asset manager for a Cayman Islands entity, could be attributed to the Cayman Islands entity for the purpose of determining whether such offshore entity was engaged in a US trade or business through agency principles.

The Tax Court further determined that the offshore entity, through the onshore entity, was engaged—on a regular and continuous basis—in the provision of financial services to companies seeking funding, which went beyond trading and investment and therefore was not covered by the safe harbor under Section 864(b)(2)(A) of the Internal Revenue Code of 1986 (the Code), as amended. Although the Tax Court decision was based on the specific terms among the parties, it serves as a reminder for non-US investment funds to pay special attention to how their investment management relationships are structured.

California Adopts Climate Disclosure Laws

The California legislature adopted two landmark climate bills that will require large public and private companies "doing business in California" to make certain climate-related disclosures starting in 2026. Senate Bill 253 requires US companies with annual revenues exceeding $1 billion to disclose publicly their greenhouse gas emissions data, and Senate Bill 261 requires US companies with annual revenues exceeding $500 million to submit to the regulators and publish on their websites reports of climate-related financial risks.

With respect to the former, the cost of compliance could be substantial in that firms doing business in California likely will first have to engage in substantial data collection and measurement efforts to facilitate public reporting.

California to Require Venture Capital Companies to Make Diversity Disclosures

Under California Senate Bill 54, the Investing in Equity Act, venture capital companies and companies making venture capital investments that have California-based operations, investments, or investors will be required, beginning in March 2025, to report to regulators information about the amounts and number of investments they make in diverse founder teams.

California Introduces Digital Asset Regulations

In October, California became the third state to introduce a licensing regime for those engaged in cryptocurrency activity (following New York and Louisiana). The California Digital Financial Assets Law (DFAL)—a combination of Assembly Bill 39 and Senate Bill 401—established licensure requirements, ongoing compliance obligations, internal control requirements, insurance obligations, disclosure requirements, stablecoin approvals, and restrictions on operation of digital financial asset kiosks, starting in July 2025.

The new laws will require companies engaging in digital financial asset business activities with or on behalf of a resident of California to apply for a license from the California Department of Financial Protection and Innovation (DFPI), although applicants that hold a license to conduct virtual currency business activity pursuant to the New York BitLicense regulations may be issued a conditional license, provided that the New York license was issued or approved no later than January 1, 2023.

The DFAL also imposes requirements on stablecoin issuers and requires an approval by the commissioner of the DFPI of any stablecoin before it can be exchanged, transferred, or stored in California or with California residents. Navigating such state-specific licensing requirements—which also requires monitoring of moving regulatory targets—represents an additional legal hurdle for private fund managers offering crypto strategies and could also involve substantial monetary penalties for managers that fail to comply with the new rules.

California Codifies a Prohibition on Noncompete Agreements

Effective January 1, 2024, noncomplete agreements are prohibited in California pursuant to Assembly Bill 1076 and Senate Bill 699. SB 699 makes it unlawful for employers to enforce agreements that are void and unenforceable under Business and Professions Code Section 16600. SB 699 also prohibits employers from entering into a contract with an employee or a prospective employee that includes a provision that is void and unenforceable under Business and Professions Code Section 16600.

AB 1076 requires employers of California-based employees to notify in writing, by February 14, 2024, all current and former employees (who were employed after January 1, 2022) that any noncomplete clauses or agreements previously signed by the employees are void. Certain narrowly construed exceptions continue to apply with respect to sales of business, LLC memberships, and partnerships.

FTC Proposes Banning Noncompete Clauses

In yet another example of new employment practice requirements, the US Federal Trade Commission's (FTC's) January 2023 proposal would prohibit employers from entering into, attempting to enter into, or maintaining noncompete restrictions on their "workers," or from representing to their workers that they are subject to noncompete restrictions without a good-faith basis to believe that the workers are, in fact, subject to legally enforceable noncompete restrictions.

Regulations Applicable to Sovereign Wealth Funds

In the category of good news for some investors, the proposed regulations under Section 892 of the Code should benefit foreign government investors in private funds and other entities that own US real estate by making it easier for those investors to structure their holdings of those investments in a manner that preserves such investors' eligibility for the Section 892 exemption. Until the final regulations are issued, taxpayers may rely on the proposed regulations under Section 892.

Use of Technologies by Broker-Dealers and Investment Advisers

If adopted as drafted, the rules proposed in July 2023 would impose restrictions on how broker-dealers and investment advisers communicate with clients and prospective clients and how discretionary investment advisers manage client accounts. The proposed rules would require that firms eliminate or neutralize the effect of conflicts of interest that result from the use of covered technologies when interacting with investors (and prospective investors). If the SEC moves forward with a final rule, we expect – perhaps optimistically – that it will be more narrowly tailored.

CFTC Aims to Regulate Voluntary Carbon Markets

In December, the CFTC issued proposed guidance addressing derivative contracts on voluntary carbon market products traded on CFTC-regulated exchanges. The proposal identifies criteria that should be addressed clearly in the design of a voluntary carbon credit derivative contract to help ensure that trading in the contract is based on accurate information about the underlying voluntary carbon credit.

Cybersecurity Incident Reporting and Broker-Dealer Cyber Risk Management Requirements

On March 15, the SEC issued a notice of proposed rulemaking that would require SEC-registered investment advisers, investment companies, and broker-dealers to provide notice to individuals affected by certain types of data breaches, along with other related requirements. The proposed rules are a part of a spate of privacy proposals issued by the SEC and follows other recent proposals.

DOL'S New Fiduciary Proposal: Same as Vacated 2016 Rule

The US Department of Labor's (DOL's) proposed Retirement Security Rule (also known as DOL Fiduciary Rule 4.0) brings back many concepts from its 2016 fiduciary rule, which was vacated by the Fifth Circuit. Although litigation (and other challenges) involving the DOL's Retirement Security Rule is likely, its outcome is uncertain; therefore, impacted firms should consider approaches to implementation.

Potential New Regulations of US Outbound Investments

The Committee on Foreign Investment in the United States (CFIUS) has long screened foreign investments in the United States. Fund managers and their investors should be aware of a flurry of activity in both the executive and legislative branches regarding governmental review of investments outside of the United States in certain sectors or technologies. Specifically, a Senate Bill passed in July 2023 would require US persons to notify the US government before engaging in commercial arrangements in certain sectors with entities in "countries of concern" (i.e., China, Russia, Iran and North Korea).

Also in August, President Biden issued an executive order that established an "outbound investment program" and ordered the US Department of Treasury to develop proposed rules to prohibit or require notification of certain outbound investments into "countries of concern."

The Treasury Department issued an advance notice of proposed rulemaking to collect information on the contours of an outbound investment program and is currently evaluating the comments received in response. The Treasury Department expects to issue proposed rules upon completion of its analysis of the interested party reactions to the information collection process. No timelines for the proposed rules have been announced yet.

CONCLUSION

From a legal and regulatory perspective, 2023 was an extremely eventful year for private fund managers and investors. Having now turned the page to 2024, with many laws, rules, and regulations still in the proposal or pre-proposal phase, it seems like the current year could be just as noteworthy as last year, promising to bring additional challenges and increased time demands on in-house legal counsel and compliance professionals.

Morgan Lewis will continue to stay on top of these new developments to help private fund advisers navigate all the points at which their businesses intersect with an increasingly complex legal and regulatory environment.

With respect to the tax items described above, please see our thought leadership for further discussion and other notable 2023 tax developments.

CONTACTS

If you have any questions or would like more information on the issues discussed in this report, please contact any of the following:

Authors

Stephen C. Tirrell	+1.617.951.8833	stephen.tirrell@morganlewis.com
Jack O'Brien	+1.215.963.4969	john.obrien@morganlewis.com
Christine M. Lombardo	+1.215.963.5012	christine.lombardo@morganlewis.com
Marina Kofsman	+1.415.442.1394	marina.kofsman@morganlewis.com
Patrick Lucke	+1.312.324.1795	patrick.lucke@morganlewis.com
Mark E. Conrad	+1.202.739.5287	mark.conrad@morganlewis.com

ABOUT US

Morgan Lewis is recognized for exceptional client service, legal innovation, and commitment to its communities. Our global depth reaches across North America, Asia, Europe, and the Middle East with the collaboration of more than 2,200 lawyers and specialists who provide elite legal services across industry sectors from multinational corporations to startups around the world. For more information about us, please visit www.morganlewis.com.