Private equity in registered products

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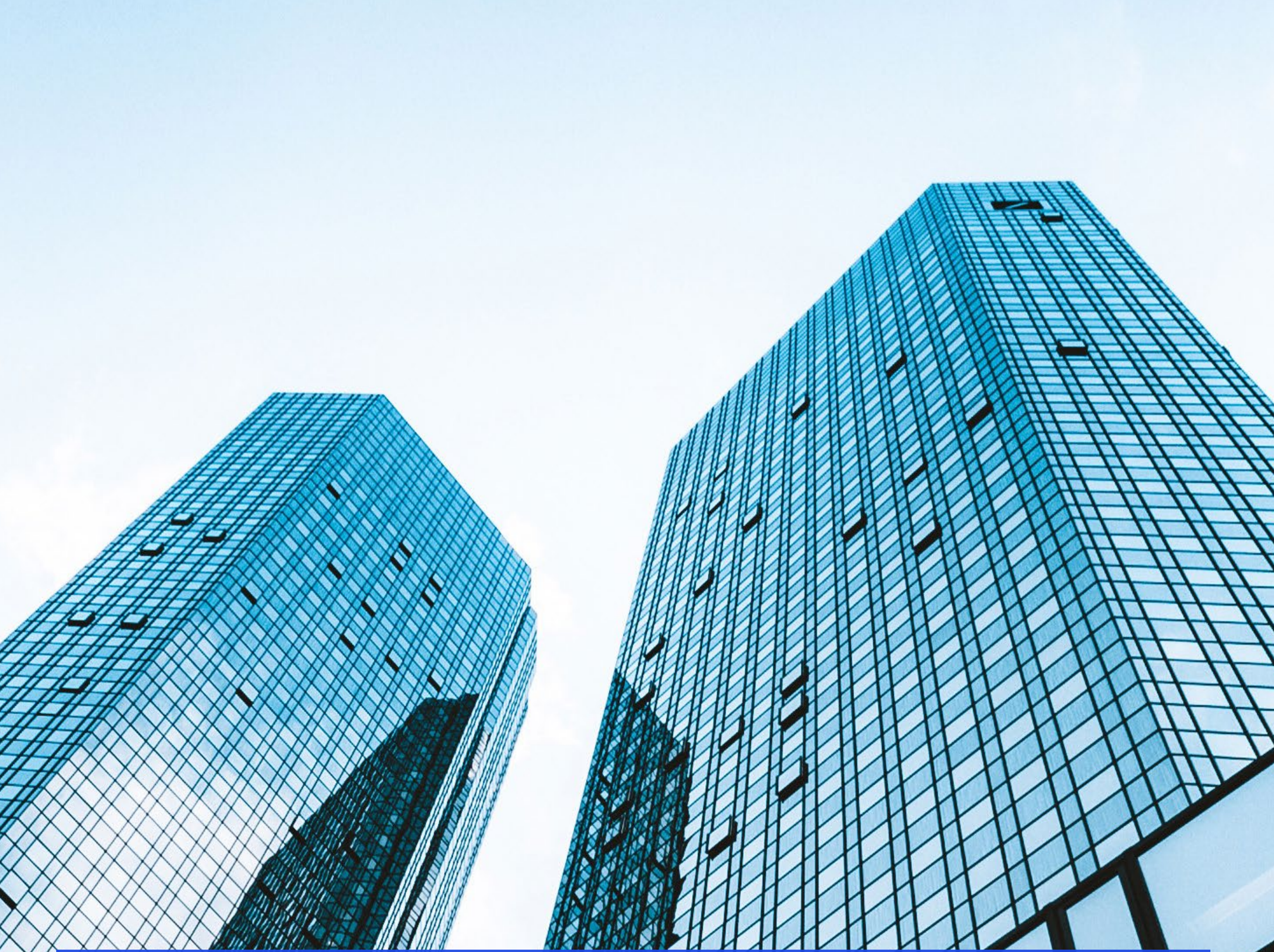


Asset managers are continuing to expand the availability of alternative investments to high-net-worth and retail investors through investment pools and funds registered with the U.S. Securities and Exchange Commission (“SEC”). While private credit has seen significant growth of late, other alternative investments like private equity, infrastructure and fund of funds invested in these asset classes are increasing in popularity in these registered products.

This article will focus on the latest trends in registered products specific to private equity, as well as key considerations and challenges for launching and operating these products.

Fund structures and investment vehicles

The following is an overview of key features for different types of registered products investing in private equity that have been launched over the past couple of years.

	Registered funds (Investment companies)		Private placements[1]	
	Interval Funds	**Tender Offer Funds**	**Perpetual investment vehicle (non-traded)**	**Operating company**
Structure	Unlisted closed-end funds, registered under Investment Company Act of 1940 (" '40 Act")	Unlisted closed-end funds, registered under the '40 Act	Registered under Securities Exchange Act of 1934 ("Exchange Act") Section 12(g), private fund exempt from registration under Section 3c7 of the '40 Act	Registered under Securities Exchange Act of 1934 Section 12(g), with intention to operate as a business investing in general partner and controlled joint venture interests that do not meet the definition of "investment securities" to avoid qualifying as an investment company under the '40 Act
SEC Oversight	Division of Investment Management	Division of Investment Management	Division of Corporation Finance	Division of Corporation Finance
Share Purchase Terms and Investors	• Periodic share purchases sometimes on a daily basis with the price based on the fund's NAV • No restrictions on type of investor	• Periodic share purchases often on a monthly or quarterly basis • No restrictions on type of investor	• Periodic subscriptions as part of a continuous private offering under Regulation D and Regulation S (for non-US investors)	• Periodic subscriptions as part of a continuous private offering under Regulation D and Regulation S (for non-US investors)
Tax status	Expects each year to qualify as a RIC for U.S. federal income tax purposes	Expects each year to qualify as a RIC for U.S. federal income tax purposes	Intended to be treated as a partnership for income tax purposes	Intended to be treated as a partnership for U.S. federal income tax purposes, and not as a publicly traded partnership taxable as a corporation

[1] Private placements in accordance with Regulation D of the Securities Act of 1933.

	Registered funds (Investment companies)		Private placements[1]	
Repurchase offers	• Conducted at regular intervals (quarterly, semiannually or annually) pursuant to Rule 23c-3 of the ’40 Act • “Fundamental policy” to offer to repurchase between 5%–25% of its shares, with discretionary repurchases subject to self-imposed restrictions • Price = NAV calculated on repurchase pricing date	• Board has discretion for tendering shares for repurchase, subject to Exchange Act requirements in Rule 13e-4 of the Exchange Act • Tender offer amount at board discretion • Price determined by “tender offer best-price rule” (Rule 13e-4(f)(4), whereby all shareholders must be offered same price per share)	• General Partner has discretion for tendering shares for repurchase, subject to Exchange Act requirements in Rule 13e-4 • Tender offer amount at General Partner discretion • Price = Transactional NAV[1] or actual NAV	• Discretionary, with targeted share repurchase plan • Price = Transactional NAV[2] or actual NAV
Distributions	Distribute at least 90% taxable income and realized gains to maintain RIC tax qualification	Distribute at least 90% taxable income and realized gains to maintain RIC tax qualification	Discretionary	Discretionary
NAV frequency	Calculates NAV at least weekly, and on each day that investors purchase shares and at least daily during 5 business days before repurchase request deadline.	Periodic, typically on days that investors are allowed to purchase or redeem shares	Periodic. For example, calculated monthly and for repurchase offers	Periodic. For example, calculated monthly and for repurchase offers

[1] Private placements in accordance with Regulation D of the Securities Act of 1933.
[2] Transactional NAV is calculated based on a policy approved by the Board, with common adjustments to GAAP NAV.

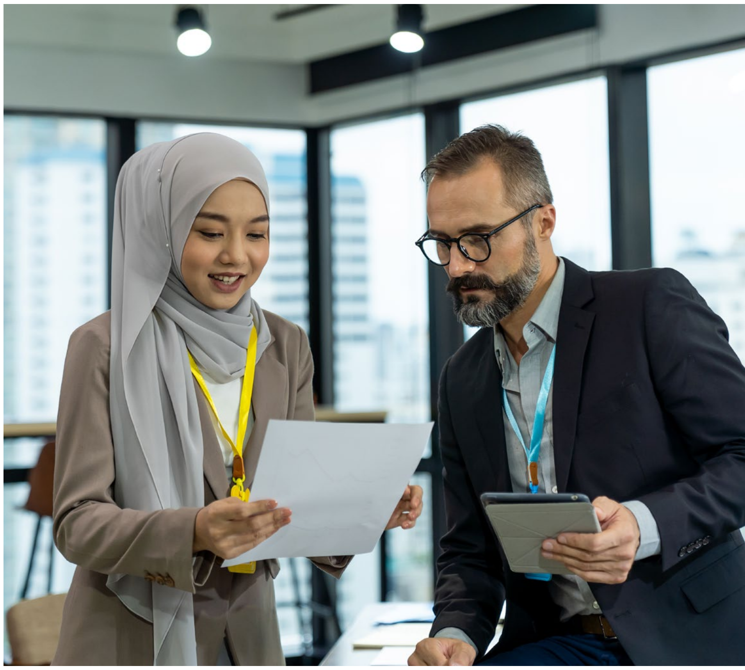
	Registered funds (Investment companies)		Private placements[1]	
Leverage	Under the '40 Act, must meet asset coverage limitations of 300%, or 200% of preferred stock. Any senior securities or other debt must mature or be repayable before the next repurchase pricing date to ensure sufficient liquidity for meeting repurchase obligations	Under the '40 Act, must meet asset coverage limitations of 300%, or 200% of preferred stock	No restrictions	No restrictions
Liquidity requirements	Not subject to SEC Liquidity Rule 22e-4, but the Board must adopt written procedures designed to ensure the fund's assets are sufficiently liquid to comply with fundamental repurchase policy and liquidity requirements to maintain 100% of repurchase offer amount in liquid assets	Not subject to SEC Liquidity Rule 22e-4 or liquidity requirements similar to interval funds but should actively monitor liquidity needs for repurchase requests	None	None
Board governance	Ultimate responsibility for managing affairs of the fund, including oversight of valuations and fundamental policy governing periodic repurchase offers. Members of board are subject to fiduciary duties carrying out their responsibilities and are limited to composition rules of '40 Act	Ultimate responsibility for managing affairs of the fund, including oversight of valuations. Members of board are subject to fiduciary duties carrying out their responsibilities and are limited to composition rules of '40 Act	Overall responsibility rests with the General Partner, subject to oversight rights by the Board of Directors	Board's corporate governance responsibilities based on fiduciary duties applicable to jurisdiction of incorporation

[1] Private placements in accordance with Regulation D of the Securities Act of 1933.

Operational considerations

Implementing an investment strategy with alternative, illiquid investments in these registered products can create operational challenges for CFOs, including:

- Managing liquidity and cash flows for redemptions and/or dividend payments, including consideration of optimal mix of investments (illiquid securities vs. cash and liquid securities)
- Implementation and monitoring of a robust valuation process for periodic NAV calculations
- Effective deployment of capital to generate returns, including pipeline of opportunities and changes to the due diligence process



When planning to operate these products, there are other roles and responsibilities to be considered:

Custodian	**Registered funds** • Use of a qualified custodian to hold the fund's investments in securities for '40 Act vehicles • If fund elects to self-custody investments in securities, must comply with the requirements of Rule 17f-2 under the '40 Act **Private placements** • Investment advisor is subject to SEC custody rule with respect to securities.
Transfer agent	• Processes issuance and redemption of shares, while maintaining accurate shareholder records • If adviser or management company will act as transfer agent, consider regulatory requirements and managing potential conflicts of interest
Distributor	• Distribution channels to market and sell fund's shares to investors
Legal and compliance	• Policies and procedures to ensure compliance with regulatory requirements

Reporting and regulatory requirements

These registered products have specific reporting and regulatory requirements, including:

Registered funds	Private placements
Calculating NAV	
US GAAP NAV (no adjustments)	Transactional NAV may be calculated based on policy approved by Board, with common adjustments to US GAAP NAV including the accrual of servicing and distribution fees for the estimated life of shares as an offering cost at the time of sale.
Annual reports and other SEC filings	
Interval and tender offer funds comply with reporting requirements for '40 Act funds, including Form N-2 (registration), Form N-CSR (annual and semi-annual reports to shareholders), Form N-PORT (monthly portfolio holdings) and Form N-CEN (annual report).	The private placement products file registration statements using Form 10-12G and are subject to Section 13(a) of the Exchange Act, which require filing of annual reports on Form 10-K and quarterly reports on Form 10-Q.
Internal control and governance	
Subject to Rule 38a-1 of '40 Act to ensure integrity of internal controls, financial reporting, and compliance with regulatory requirements.	• Subject to Sarbanes-Oxley Act (SOX) and related rules and regulations promulgated by SEC. • Management required to report on internal control over financial reporting pursuant to Section 404 of SOX if criteria are met.

Accounting

The following accounting matters are highlighted for consideration:

Investment company accounting

For all registered products within this article, including the operating companies, the financial statements are prepared using the accounting and reporting guidance under ASC 946 (Financial services –Investment Companies).

Consolidation

Generally as provided under ASC 946 and Regulation S-X, these entities do not consolidate investments in a company other than a wholly owned investment company or controlled operating company whose business consists of providing services to the investment company.

Calculating NAV

The private placement products may use Transactional NAV for the purchase and redemption of shares. Transactional NAV is calculated based on a policy approved by Board, with common adjustments to GAAP NAV including the accrual of servicing and distribution fees for the estimated life of shares as an offering cost at the time of sale.

Distribution and Servicing fees

For interval and tender offer funds, ongoing servicing and distribution fees (like 12b-1 fees) are typically expensed as incurred.

For some private placement products, these fees are treated more like offering costs and are being accrued and amortized over the estimated life of the shares at the time of sale.

The accounting treatment will depend on the nature of the fee, what service the fee pertains to and how and when that service is provided.

Incentive or Performance fees

For registered funds, performance or incentive fees are based on income (not capital gains or appreciation), unless investors are limited to “qualified clients” under the ‘40 Act.

For private placement products, performance fees are commonly structured with an annual performance hurdle amount and a high-water mark with GP catch-up. These performance fees are typically measured on a calendar year basis and paid (or allocated) on a quarterly or annual basis.

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Valuation

These products have different regulatory requirements that must be followed when determining fair value.

Registered funds	Private placements
Under Rule 2a-5 of the '40 Act, a fund must adopt policies and procedures to determine fair value in good faith for any securities without readily available market quotations. This includes establishing a valuation governance structure, conducting periodic reviews and updates, and ensuring proper oversight by the fund's board of directors. The rule mandates that funds must employ a consistent and comprehensive approach to valuation, which includes appropriate methodologies, testing, and documentation. Additionally, funds must maintain records supporting their fair value determinations for a specified period.	There is not a specific framework for valuation practices, other than complying with US GAAP (i.e. FASB ASC 820 – Fair Value Measurements).

Despite this, we expect the framework for valuation policies to be relatively consistent across the different products given the underlying investments. However, the regulatory framework will influence the extent and nature of the procedures used in estimating fair value and related recordkeeping requirements.

Often, private equity managers employ dedicated valuation professionals as well as portfolio managers who are involved in the process of quarterly valuations of private equity investments. Valuing private equity investments requires maintaining valuation models and applying sophisticated financial modeling techniques.

Each period, the valuation process involves collecting information from portfolio companies, rolling forward valuation models for the passage of time, updating market data, inputting updated company-specific financial metrics, and applying valuation judgments to conclude on fair value. Once prepared, these valuations undergo internal reviews and valuation committee approvals before reporting NAVs to investors.

Performing valuations more frequently than quarterly can present certain challenges. First, intra-quarter valuations may face company-specific data limitations. For example, the valuation team might not have updated performance data for the company being valued compared to the prior period valuation. However, even if updated company specific information is lacking, the valuer can evaluate the private equity investment relative to the performance of comparable publicly traded companies for which data is available. One must be careful, however, to not simply peg a private equity valuation to market multiples or indices without appropriate correlation and calibration. Private equity investments tend to be less volatile and not 100% correlated with public equity investments, and thus require professional judgement in concluding on value. Second, the professionals involved in the valuation process may be too resource constrained to perform or oversee valuations more frequently than quarterly. It is not uncommon for those involved in the valuation process, including the valuation committee – which often consist of senior partners/managing directors, the CFO, head of valuation, investment professionals, legal and compliance representatives, who review and are the final approvers of the valuations each period – to have other responsibilities besides quarterly valuations, such as activities related to portfolio monitoring, investment support, fundraising support, financial reporting, fund-level financial planning and analysis and other overall management responsibilities.

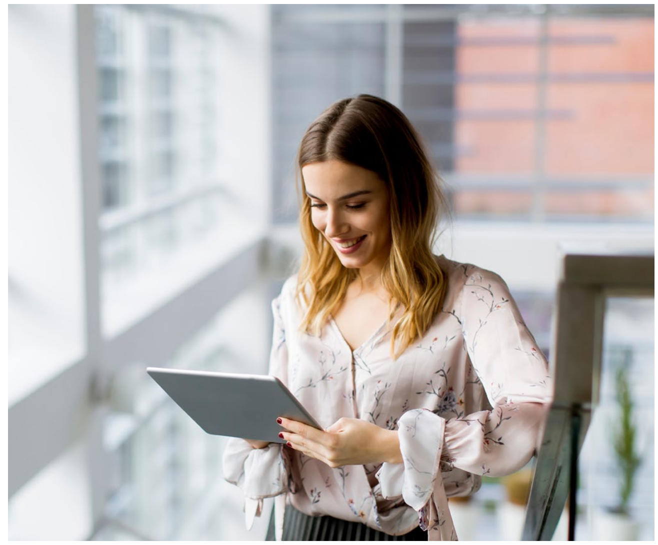
To maintain frequent valuations, the private equity manager needs to either expand their internal teams or outsource all or part of the responsibilities. The industry trend, especially among larger private fund managers, has been to maintain a lean internal valuation team and reduce the time portfolio managers spend on the valuation process. To scale the valuation process, fund managers are increasingly hiring external firms such as accounting and valuation firms to provide support in the form of independent valuations or managed services. By leveraging an external firm, the valuation and portfolio management teams at private fund managers can gain leverage in their valuation process and focus on the highest value-add activities.

Mutual fund managers, which typically manage open-ended funds and offer their primarily retail-based investors daily liquidity, face a different set of valuation challenges as they move to increase investment in private assets. Because mutual funds typically invest in liquid assets, such as public equity and credit, they may lack the specialized personnel and infrastructure for performing private equity valuations. To establish an infrastructure to value private equity investments, a mutual fund manager must enhance existing valuation policies and procedures, establish a valuation governance structure with a qualified valuation committee to review and approve private equity valuations, and identify personnel that are qualified to perform the valuations in a well-documented manner that meets internal and external stakeholder requirements. Common options for performing the valuation function include internal teams consisting of portfolio managers and dedicated internal valuation personnel, external firms that specialize in the valuation of private equity, or a combination of both via an internal/external hybrid model. The decision on how to build the infrastructure for performing valuations depends on several factors, including the required frequency of the valuations, the target number of investments or asset under management (AUM) of the fund, and the long-term plans for the number of private equity funds expected to be raised in the future.

	Alternative asset managers	Public asset managers
Goal	Calculate NAV for subscriptions and redemptions on a frequent basis (daily, weekly, or monthly) to meet the requirements of investors, regulators, and other stakeholders.	
Existing processes and procedures	• Expertise in private equity valuations and processes • May lack the infrastructure for monthly or more frequent valuations	• Established processes and infrastructure for 40 Act Funds to implement frequent valuations • May lack expertise in private equity valuations, governance, people and processes
Challenges	Scaling the current quarterly valuation processes to meet frequent valuation and NAV needs (daily/weekly/monthly)	Setting up and maintaining governance, processes, and procedures pertaining to private equity and/or other alternative investment valuations

Tax

A ’40 Act fund is generally taxed as a Regulated Investment Company (“RIC”). RICs have a favorable tax treatment as they are able to deduct dividends paid or dividends deemed to be paid by the RIC, preventing double taxation. RICs can also pass through treatment for certain components of income to its shareholders. A corporation can only take advantage of the favorable tax treatment for RICs if it meets, and continues to meet, certain Internal Revenue Code (“IRC”) requirements.



Key elements for qualification as a RIC:

01 Elect RIC Status:

The ’40 Act fund must elect to be taxed as a RIC, which is made with the filing of the tax return, Form 1120-RIC. (IRC Section 851(b)(1)

02 Distribution Requirements:

RICs need to annually distribute at least 90% of investment company taxable income and net tax-exempt income to shareholders. (IRC Section 852)

03 Income Source Requirements:

A RIC must derive at least 90% of its income from qualifying sources, passive type income. A few examples of qualifying sources are dividends, interest, payments with respect to securities loans, gains from the sale or disposition of stocks, and foreign currencies. Other income derived from the investment securities and net income derived from an interest in a qualified publicly traded partnership. (IRC Section 851(b)(2))

04 Asset Diversification:

At the close of each quarter of a RIC’s tax year, a RIC must satisfy 50% and 25% asset diversification tests. At least 50% of a RIC’s total assets measured by value must be invested in cash and cash items (including receivables), government securities, RIC securities, and certain “other securities.” Other securities cannot be more than 5% of the value of the RIC’s total assets or more than 10% of the issuer’s voting stock. At most, 25% of the value of a RIC’s total assets may be invested in the securities of any one issuer, or multiple issuers that the RIC controls (defined as owning 20% or more of the outstanding voting securities of a corporation)

U.S. Investors in RICs typically receive the following tax forms:

1

Form 1099-DIV

This form reports dividends and distributions received from the RIC. It includes details on ordinary dividends, qualified dividends, and capital gain distributions

2

Form 1099-B

If the investor sells shares of the RIC, this form reports the proceeds from the sale, which is necessary for calculating capital gains or losses

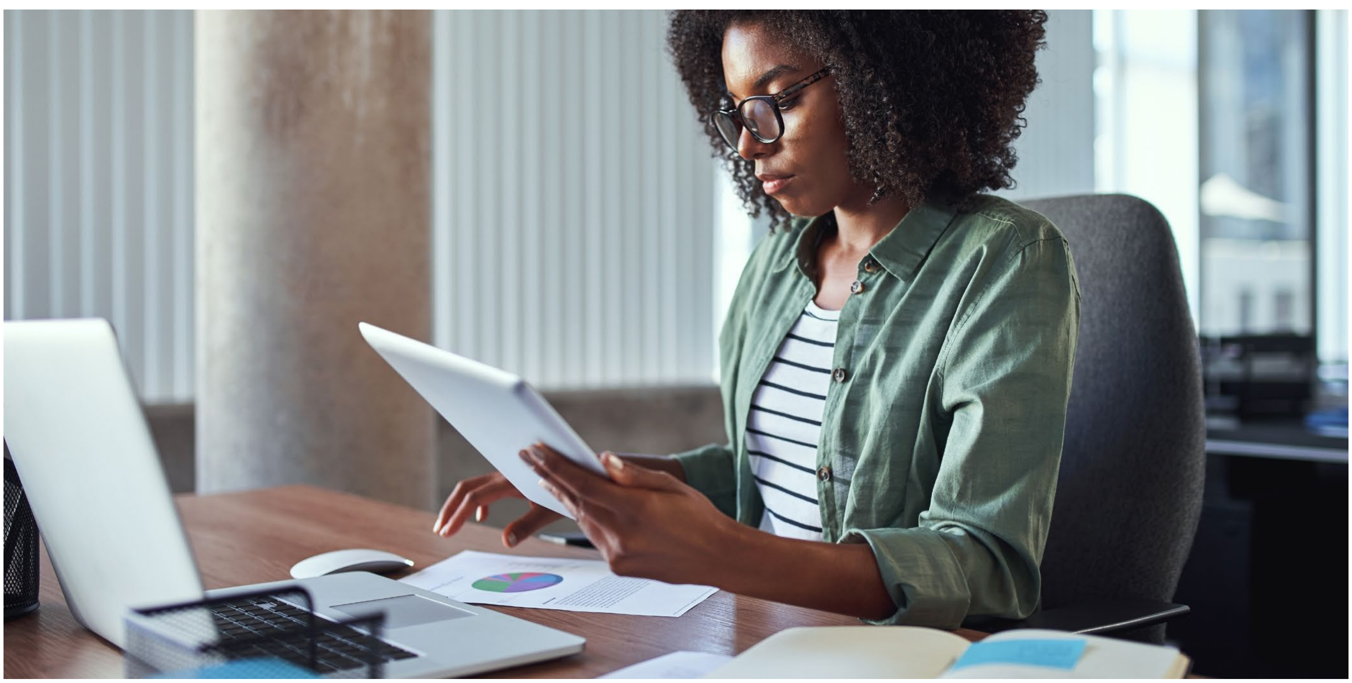
3

Form 2439

If the RIC retains capital gains instead of distributing them, this form reports the undistributed capital gains and the taxes paid on behalf of the investor

Foreign investors in RICs typically receive a Form 1042-S which reports similar items that are reported on U.S. forms mentioned above for foreign investors.

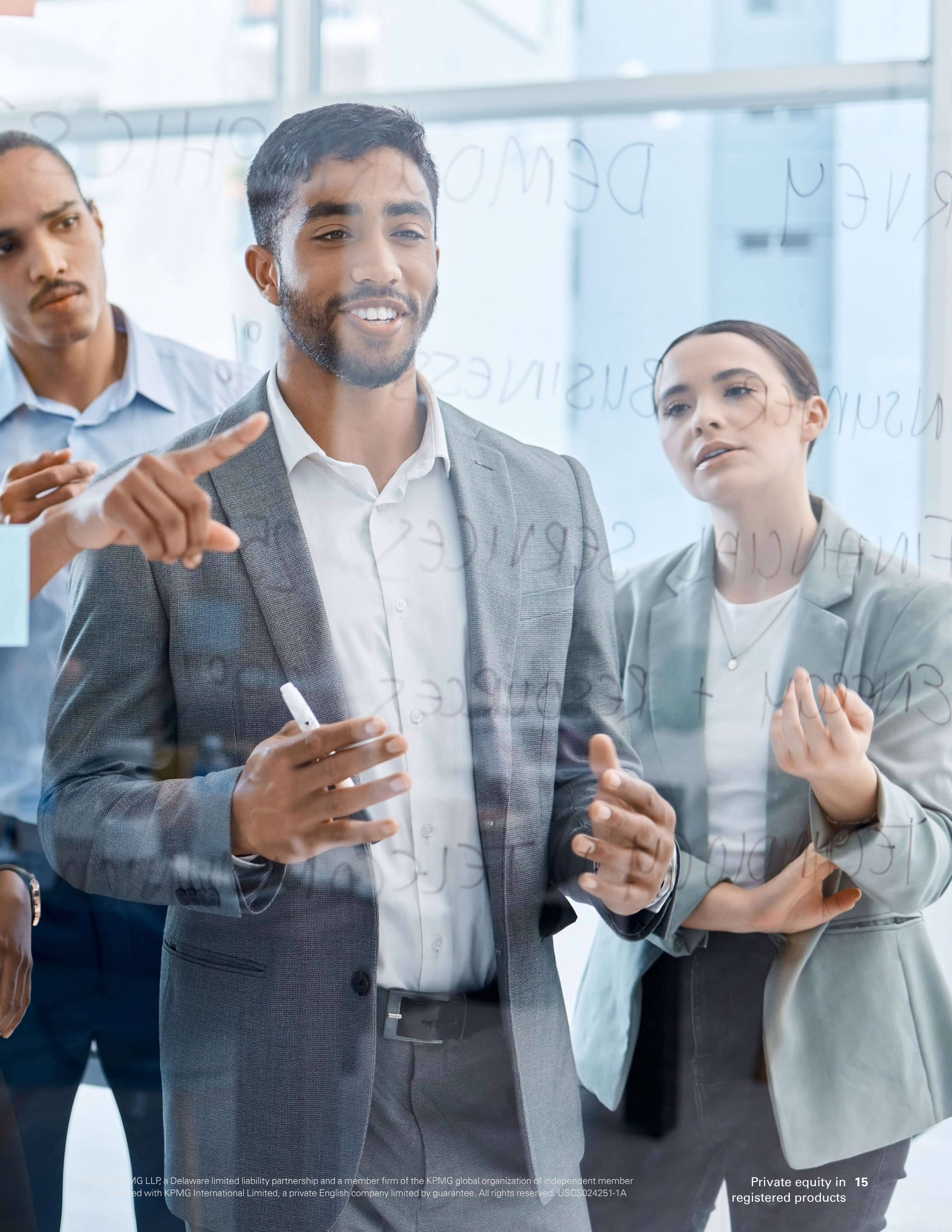
For the Private placements, partnership taxation applies. Partnerships are considered “pass-through” entities, meaning they generally do not pay income tax at the partnership level. Instead, income, deductions, gains, and losses are passed through to the partners, who report these items on their income tax returns. A partnership files Form 1065 (U.S. Return of Partnership Income) annually and provides the partners in the partnership with a Schedule K-1 (Form 1065) which details their share of the partnership’s income, deductions, credits, and other items. Partners use this information to complete their individual, corporate, or other appropriate tax returns.



How KPMG can help

KPMG is pleased to offer a full suite of services and products to meet the specific needs of this specialized market during all stages of the entity's life, including at design and launch.

- **Accounting and reporting advice**
- **Advice on the design and operation of internal control**
- **Audit and attestation services**
- **Valuation services**
- **Tax consulting and compliance**
- **Advice on operations, technology and service providers**
- **Compliance assistance and advice**
- **Distribution strategy and advice**
- **Investor reporting strategy and advice**



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