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WELCOME

K&L Gates Asset Management and Investment Funds Conference

San Francisco

November 13, 2023

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AGENDA

1. Welcome
2. SEC Enforcement Actions and Examination Priorities
3. Private Fund Adviser Rule
4. ESG Developments for Managers
5. LP Trends
6. Reception

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SEC Enforcement Actions and Examination Priorities

Speakers:

- Matthew Mangan, Partner - K&L Gates
- Christopher Lokken, Partner - K&L Gates

OVERVIEW

- SEC Exam Priorities and Risk Alerts
  - 2024 Exam priorities for private fund managers
- SEC Enforcement Updates
  - Increased size of enforcement penalties so they are more than just a cost of business and continued focus on individual accountability
  - “Proactive compliance requires education, engagement and execution,” says Enforcement Director Grewal
  - Sweeps related to marketing rule, custody rule and off-channel communications
  - Concurrent enforcement, examination presence, and rule making initiatives
  - Crypto enforcement and litigation

SEC EXAM PRIORITIES AND RISK ALERTS

2024 SEC EXAMINATION PRIORITIES

- Adjusted timeframe for announcement of Examination Priorities by the Division of Examinations
  - 7 February 2023 – Examination Priorities for FY 2023 Announced
  - 16 October 2023 – Examination Priorities for FY 2024 Announced
- Provides examination focus areas for specific market participants and particular “risk areas,” with overall focus on strong compliance processes and examinations concerning new SEC rules
- ESG issues dropped from FY 2024 Examination Priorities

2024 SEC EXAMINATION PRIORITIES

Investment Advisers

- Examining for advisers' adherence to their duty of care and duty of loyalty by focusing on products, processes, conflicts of interest, economic incentives of adviser and financial professionals, and disclosures
- Focus on compliance programs and annual reviews
- Particular exam focus areas will include:
  - Marketing practices, including compliance with the marketing rule
  - Compensation arrangements and reasonableness of fees
  - Valuation of difficult-to-value assets, such as commercial real estate
  - Safeguarding assessments for advisers' controls to protect MNPI
  - Disclosure assessments to review accuracy and completeness of regulatory filings
- Focus on policies and procedures for: (1) selecting and using third-party and affiliated service providers; (2) oversight of branch and dispersed offices; and (3) obtaining informed consent from clients when advisers change advisory agreements

2024 SEC EXAMINATION PRIORITIES

Private funds remain a focus area generally and the following will be prioritized topics:

- Portfolio management risks present with market volatility and higher rates
- Adherence to contractual requirements regarding LPACs and advisory boards – including contractual notification and consent processes
- Accurate calculation of fees and expenses, including:
  - Valuation of illiquid assets
  - Calculation of post commitment period management fees
  - Adequacy of disclosures
- Due diligence practices for consistency with policies, procedures and disclosures
- Conflicts of interest
- Custody rule compliance, including accurate Form ADV reporting, timely completion and distribution of audits
- Policies and procedures for reporting on Form PF, including on the occurrence of certain reporting events

2024 SEC EXAMINATION PRIORITIES

Information Security & Operational Resiliency

- Review of cybersecurity policies and procedures, internal controls, oversight of vendors and responses to cyber-related incidents
- Employee training programs concerning identity theft prevention and the protection of customer information
- Compliance with recently adopted rules shortening settlement cycle to one business day after trade date (May 28, 2024)

2024 SEC EXAMINATION PRIORITIES

Crypto and Fin Tech

- Examination of automated tools and AI used in investment services space
- Procedures governing recommendations of crypto products and related discussions with retail customers

AML (new)

- Examination of AML procedures and compliance with Bank Secrecy Act and whether programs are tailored to the unique AML risks associated with business model
- Focus on independent testing, customer identification program, SAR filing obligations, and OFAC compliance

DIVISION OF EXAMINATIONS RISK ALERTS

Examinations Focused on New Marketing Rule (Sept. 2022, June 2023)

- Noting an "initial" initiative towards compliance with the marketing rule focused on policies and procedures, the substantiation requirement, and performance advertising requirements (Sept. 2022)
- Specifying "additional areas" for examination, including use of testimonials and endorsements, third-party ratings, and Form ADV disclosures (June 2023)

Safeguarding Customer Records and Information at Branch Offices (Apr. 2023)

- Specifying common issues with respect to Reg S-P compliance, with focus on addressing safeguards for branch offices in particular
- Areas of weakness or deficiency observed in examinations include with respect to vendor management and oversight, email configuration, data classification, access management, and technology risk

DIVISION OF EXAMINATIONS RISK ALERTS

- *Assessing Risks, Scoping Examinations, and Requesting Documents* (Sept. 2023)
  - Describing a risk-based approach to selecting firms to examine with consideration of prior examinations, disciplinary history, tips and referrals, type of business activity, length since last exam, media reports, material changes in leadership, and third-party data, among other factors
  - Stating that examinations typically involve review of operations, disclosures, conflicts of interest, and compliance practices, as well as custody and safekeeping of client assets, valuation, portfolio management, fees/expenses, and brokerage and best execution
  - Identifying typical requests for information in an examination (general information, compliance program, risk management, internal controls, trading activities)

ENFORCEMENT STATISTICS, TRENDS, AND IMPORTANT ACTIONS

SEC ENFORCEMENT STATISTICS

- FY 2023 enforcement statistics are expected to be released by the SEC very soon Chair Gensler offered a preview:
  - 780 total actions filed, including over 500 standalone actions
  - Judgments and orders totaled over $5 billion
  - Over $925 million distributed to harmed investors
- FY 2022
  - 760 total actions filed, including:
    - 462 new enforcement actions (6.5 percent increase from FY 2021)
      - More than two-thirds involved at least one individual defendant or respondent
    - 129 actions against issuers delinquent in required SEC filings
    - 169 “follow-on” administrative proceedings seeking individual bars based on criminal convictions, civil injunctions, or other orders
  - Nine percent increase over the total actions filed in FY 2021
- SEC seeks a budget of $2.436 billion for FY 2024, which is over $300 million more than it sought in FY 2023

ENFORCEMENT-RELATED DEVELOPMENTS

Director Grewal's Remarks to the New York City Bar Association Compliance Institute, October 24, 2023

- Importance of creating a culture of ***proactive*** compliance which has three elements: ***education, engagement and execution***
- "***We put a lot of thought into making sure that our charging documents….clearly telegraph the basis of the misconduct to industry participants****."*
- Emphasis on cooperation, self-reporting, and remediation when securities violations occur. Other actions that have reduced penalties include:
  - Preemptively remediating and ceasing unlawful behavior
  - Proactively providing compensation
  - Identifying key documents and witnesses to the staff
  - Providing analyses, explanations, summaries that the staff has not yet identified

ENFORCEMENT-RELATED DEVELOPMENTS

- Gatekeeper and compliance officer liability
  - SEC is not seeking to "second-guess[] good faith judgment calls"
  - **Three** contingencies for when to hold CCO liable:
    - Whether CCO mislead regulators
    - Whether CCO utterly failed to perform responsibilities
    - Whether CCO "affirmatively participated" in misconduct

KEY FOCUS AREAS AND NOTABLE ENFORCEMENT ACTIONS

SELECTED ENFORCEMENT ACTIONS

- Recent and Ongoing Sweeps
  - Custody rule
  - Off-Channel communications/recordkeeping
  - Marketing rule
- Fees and Expenses
- Fiduciary Duties
- Valuation
- Conflicts of Interest
- Compliance Failures
- Whistleblower Protection Rules
- ESG Disclosures, Policies and Procedures
- Gatekeepers
- Crypto

SELECTED ENFORCEMENT ACTIONS: CUSTODY RULE SWEEPS

- Second set of custody rule violation actions - almost one year after a similar set of messaging actions (Sept. 2023)
  - 5 private fund advisers charged with failing to deliver audited financials to private fund investors and/or to amend Form ADV accordingly
  - Alleged compliance failures include:
    - Failing to audit
    - Failing to deliver audited financials in a timely manner
    - Failing to promptly amend Form ADV to reflect that audited financial statements were received
    - Failing to maintain securities of certain private-equity funds with a qualified custodian
    - Failing to audit in accordance with the custody rule
  - Charged with violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, and Section 204(a) and Rule 204-1(a) thereunder.
  - Without admitting or denying the findings, the firms settled via cease-and-desist, agreed to be censured and pay civil penalties ranging from $50,000 to $225,000.

Takeaways: SEC is sending a message to private fund advisers that compliance with the custody rule is main focus. Also, crucial to update Form ADV to confirm receipt of unqualified audit opinion. Item 7.B.(1). 23.

SELECTED ENFORCEMENT ACTIONS: OFF-CHANNEL COMMUNICATIONS SWEEPS

- Recordkeeping failures associated with off-channel communications (Aug. and Sept. 2023)
  - 21 firms settled actions involving "widespread and longstanding failures" to maintain and preserve off-channel communications on personal devices (after the SEC conducted a sweep in September 2022 and charged firms over their use of off-channel communications)
  - Charged with violating Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder
  - The firms agreed to be censured and admitted the facts set forth in their respective SEC orders and acknowledged that their conduct violated recordkeeping rules
  - $1.235 billion in penalties
  - Since December 2021, 40 firms have settled actions and over $1.5 billion in civil penalties have been levied for failures to maintain and preserve electronic records

Takeaway: Anticipate additional actions brought in FY2024. Crucial to evaluate policies pertaining to electronic records preservation and the use of unauthorized communication channels and implement measures to preserve and/or flag off-channel communications

SELECTED ENFORCEMENT ACTIONS: MARKETING RULE SWEEPS

- Marketing rule violations (Aug. and Sept. 2023)
  - 9 registered investment advisers charged in an ongoing sweep for advertising hypothetical performance to the general public on their websites without adopting and/or implementing policies and procedures required by the marketing rule
    - Each of the firms advertised hypothetical performance on their websites, and two failed to maintain records of the advertisements
    - All of the firms charged with violating Section 206(4) of the Advisers Act and Rule 206(4)-1(d) thereunder
    - The two firms with record keeping failures related to the advertisements were also charged with violating Section 204(a) of the Advisers Act and Rule 204-2(a)(11) thereunder
    - Without admitting or denying the SEC's findings, all nine firms have settled via cease-and-desist, agreed to be censured and pay $850,000 in combined penalties.

Takeaway: The first action under the new marketing rule was brought less than one year after the compliance date. Compliance with the marketing rule is a high priority for the SEC, Advisers should not delay reviewing its marketing policies and procedures

SELECTED ENFORCEMENT ACTIONS: REVENUE SHARING / FEES AND EXPENSES

- *In the matter of Insight Venture Management, LLC* (June 20, 2023)
  - SEC charged private fund adviser Insight with charging excess management fees and failing to disclose a conflict of interest to investors relating to its fee calculations.
  - Certain of Insight's limited partnership agreements allowed Insight to charge management fees based on the funds' invested capital in individual portfolio investments and required Insight to reduce the basis for these fees if Insight determined that one of these portfolio investments had suffered a permanent impairment.
  - Insight charged excess management fees by inaccurately calculating management fees based on aggregated invested capital at the portfolio company level instead of at the individual portfolio investment security level, as required by the applicable limited partnership agreements.
  - Further, Insight failed to disclose to investors a conflict of interest in connection with its permanent impairment criteria. Because Insight did not disclose its permanent impairment criteria, the LPs were unaware that the criteria Insight chose were narrow and subjective.
  - Insight also did not adopt or implement written policies or procedures reasonably designed to prevent violations of the Advisers Act.
  - Charged with violating Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder.
  - Settled via cease-and-desist for a $1.5 million penalty and $3.8 million of improper fees and prejudgment interest

Takeaway: Continuing a several-years'-old trend, the SEC continues to bring actions against advisers related to disclosures and concerns regarding revenue sharing and other financial conflicts of interest

SELECTED ENFORCEMENT ACTIONS: VALUATION

- *In the Matter of Chatham Asset Management, LLC and Anthony Melchiorre* (April 3, 2023)
  - SEC charged investment adviser to mutual funds and private funds and its founder and principal for overcharging its clients fees based on NAV calculated using price data that was based, in part, on the funds' own inflated trading prices. As a result of the inflated trading prices of the securities, the net asset values of their client's funds were higher than they would have been if the rebalancing trades were removed from the market, which, in turn, resulted in higher fees being charged to and paid by the clients
  - Charged with violating Sections 206(2) and 17(a)(1) and (a)(2) of the Advisers Act.
  - Adviser and founder settled via cease-and-desist, and consented to the SEC's order, without admitting or denying its findings, that they violated Section 206(2) of the Advisers Act, and that they aided and abetted and caused violations of the Investment Company Act of 1940
  - $19.4 million in civil penalty, disgorgement, and prejudgment interest

Takeaway: Highlights SEC's continued focus on valuation, in particular in less liquid, harder-to-value securities

SELECTED ENFORCEMENT ACTIONS: VALUATION

- SEC v. Premium Point Investments LP et al. (April 20, 2023 and Nov. 7, 2023).
  - SEC charged Premium Point for engaging in a fraudulent valuation scheme that resulted in the inflation of the value of private funds Premium Point advised by hundreds of millions of dollars. The scheme relied on a secret deal where in exchange for sending trades to a broker-dealer, Premium Point received inflated broker quotes for mortgage-backed securities, as well as the use of "imputed" mid-point valuations, which were applied in a manner that further inflated the value of securities. This practice boosted the value of many of Premium Point's holdings and further exaggerated returns in order to conceal poor fund performance and attract and retain investors
  - Also charged Jeremy Shor, a trader at Premium and Premium's CEO/CIO, Anilesh Ahuja for their roles in a fraudulent valuation scheme
  - On April 20, 2023, Premium Point and Ahuja were permanently enjoined from violating the antifraud provision of Section 10(b) of the Securities Exchange Act of 1934 and Rules 10b-5(a) and (c) thereunder, Sections 17(a)(1) and (3) of the Securities Act, and Sections 206(1), (2), and (4) of the Advisers Act and Rule 206(4)-8(a)(2) thereunder; permanently enjoining Premium Point from violating Advisers Act Section 206(4) and Rule 206(4)-2 thereunder.
    - On November 7, 2023 Shor was also permanently enjoined from violating the same provisions listed above.
  - Ahuja agreed to a $450,000 penalty and industry bar. Shor was not ordered to pay a civil penalty due to his statement of financial condition

SELECTED ENFORCEMENT ACTIONS: FIDUCIARY DUTIES

- *In the Matter of American Infrastructure Funds, LLC* (Sept. 22, 2023)
  - SEC charged American Infrastructure Funds ("AIM"), a registered investment adviser to private funds for three distinct breaches of fiduciary duties, listed below, related to infrastructure investments
    1. Entered into an agreement that accelerated a portfolio company monitoring fee without timely disclosure to clients or investors
    2. Effectively locked-up client and investor money into the investment for an additional 11 years by transferring an asset owned by AIM-advised funds to a newly-formed private fund that AIM also advised without adequately disclosing its conflicts of interest, obtaining investor consent, or allowing investors to liquidate or exit their investment
    3. Made an AIM-advised fund incur expenses that should have been paid by a fund advised by an affiliated adviser
  - AIM failed to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with its receipt of compensation from portfolio companies and transfers of fund assets
  - Charged with violating Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder
  - Without admitting or denying the SEC's findings, AIM settled via cease-and-desist, agreed to be censured and pay $1.6 million in civil penalty, disgorgement, and prejudgment interest

SELECTED ENFORCEMENT ACTIONS: CONFLICTS OF INTEREST

- *In the Matter of Prime Group Holdings, LLC* (Sept. 5, 2023).
  - SEC charged Prime Group Holdings LLC, a private equity firm focused on alternative real estate asset classes, for failing to adequately disclose millions of dollars of brokerage fees paid to a real estate brokerage firm owned by its CEO
  - The SEC's order finds that the fund generally relied on deal teams comprised of Prime Group's employees and independent contractors to find and acquire "off-market" properties. The deal teams' costs and compensation, as well as other expenses of Prime Group's operations, were paid, in part, from a 3% percent brokerage fee the fund paid on the deal teams' acquisitions. The order found that the fund paid these brokerage fees to a real estate brokerage firm that was wholly owned by Prime Group's CEO and that the Prime Group made misleading statements concerning fees and conflicts of interest
  - Charged with violating of Section 17(a)(2) of the Securities Act
  - Without admitting or denying the SEC's findings, Prime Group settled via cease-and-desist order, with $20.5 million in civil penalty, disgorgement, and prejudgment interest

Takeaway: Non-RIAs should also be on notice regarding clear, accurate and adequate disclosures, in particular when related to payments made to affiliates and the potential conflicts of interest embedded in such arrangements

SELECTED ENFORCEMENT ACTIONS: COMPLIANCE FAILURES

- *In the Matter of E. Magnus Oppenheim & Co. Inc.* (March 13, 2023)
  - The SEC charged an investment adviser for failing to adopt and implement reasonably designed compliance policies and procedures, where the adviser had adopted policies from another investment adviser's compliance manual without adequate tailoring. The SEC provided notice to the firm of such deficiencies, which persisted for multiple years, in connection with an examination
  - Charged with violating Section 206(4) of the Advisers Act and Rule 206(4)-7(a) thereunder
  - Without admitting or denying the SEC's findings, adviser settled via cease-and-desist order action, agreed to be censured and pay $50,000 penalty and the adviser agreed to hire an independent compliance consultant
- *In the Matter of Mortgage Industry Advisory Corporation* (Sept. 11, 2023)
  - The SEC charged an investment adviser for failing to (1) to adopt and implement adequate written policies and procedures; (2) to conduct annual reviews of its compliance program; and (3) to establish, maintain, and enforce a written code of ethics. The SEC's order noted the adviser received notice of these deficiencies during a prior SEC examination, yet failed to address these failures adequately until after an examination 15 years later raised these issues again
  - Charged with violating Sections 204A and 206(4) of the Advisers Act and Rules 204A-1 and 206(4)-7 thereunder
  - Without admitting or denying the findings, adviser settled via cease-and-desist order action, agreed to be censured and pay $100,000 penalty

Takeaway: An Adviser adopting a compliance manual needs to adequately tailor the manual to its own business and continuously review its compliance program

SELECTED ENFORCEMENT ACTIONS: WHISTLEBLOWERS

- *Release No. 97438* (May 5, 2023)
  - SEC announced the largest-ever award, nearly $279 million, to a whistleblower whose information and assistance led to the successful enforcement of SEC and related actions
  - This is the highest award in the SEC's whistleblower program's history, more than doubling the $114 million whistleblower award the SEC issued in October 2020

SELECTED ENFORCEMENT ACTIONS: ESG

- *In the Matter of DWS Investment Management Americas, Inc.* (Sept. 2023)
  - SEC charged DWS Investment Management Americas, Inc.'s ("DIMA"), an investment adviser and subsidiary of Deutsche Bank AG, for failing to adequately implement provisions of its global ESG integration policy but marketed itself as a leader in ESG, including through its marketing of its ESG integrated funds
  - DIMA marketed its strategies as subject to an ESG information tool (part of DIMA's ESG integration policy) while not ensuring that portfolio managers actually used the tool for due diligence or risk management
  - Charged with violating Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder
  - Without admitting or denying the SEC's findings, DIMA settled via cease-and-desist, agreed to be censured and pay $19 million civil penalty regarding the ESG misstatements

Takeaway: SEC is maintaining its position that investment advisers should adopt compliance policies and procedures under Rule 206(4)-7 related to the ESG investment process

SELECTED ENFORCEMENT ACTIONS: GATEKEEPERS

- *In the Matter of Theorem Fund Services, LLC (Aug. 7, 2023)*
  - SEC charged fund administrator, Theorem, for failing to respond adequately to red flags related to a fraud perpetrated against a private fund and its general partner
  - Alleged scheme involved the misappropriation and misuse of investors' funds over a five-year period. During Theorem's engagement with the fund, significant losses were incurred. However, despite these losses, Theorem, under the direction of the fund and its general partner, calculated the NAV without recognizing the losses. Theorem then, using the NAV, created investor statements that materially overstated the value of the investor's investments
  - Additionally, to facilitate this scheme, the GP, among other conduct, made repeated materially false and misleading statements to investors and prospective investors about the fund's performance that were distributed by Theorem through its online portal
  - SEC charged Theorem because under Section 203(k) of the Advisers Act and Section 8A of the Securities Act, the SEC may charge, any person that is, was, or would be a cause of another's violation, due to an act or omission the person knew or should have known would contribute to such violation of any provision of the Advisers Act or the Securities Act
  - The SEC's order finds that Theorem was a cause of the fund's and GP's violations of Section 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder and Sections 17(a)(2) and 17(a)(3) of the Securities Act
  - Without admitting or denying the SEC's findings, Theorem settled via cease-and-desist for a civil penalty of $100,000

Takeaway: SEC's robust enforcement includes a focus on gatekeeper accountability

CRYPTO ENFORCEMENT

- Seven settled crypto enforcement actions so far in 2023, involving claims against companies, executives, and promoters.
- Causes of action include:
  - Conducting unregistered offers and sales of securities in the form of crypto assets
  - Making false and misleading statements concerning crypto assets
  - Expansion to non-fungible tokens
  - Touting of crypto assets without disclosing compensation
- Investigatory focus on:
  - Digital asset offerings, digital asset exchanges, digital asset lending and staking products
  - Decentralized finance platforms, non-fungible tokens (“NFTs”), and stablecoins

SELECTED ENFORCEMENT ACTIONS: CRYPTO

- *SEC v. Bittrex, Inc.* (April 17, 2023)
  - SEC charged crypto asset trading platform Bittrex, Inc. and its co-founder for operating an unregistered national securities exchange, broker, and clearing agency
  - Bittrex allegedly directed issuers of crypto assets to “scrub” their public statements of any language that could raise questions from the SEC as to whether these crypto assets were offered and sold as securities, while allowing those securities to be traded on its platform
  - Charged with violating Sections 5, 15(a), and 17A(b) of the Exchange Act
  - Without admitting or denying the SEC’s findings, Bittrex settled agreeing to pay $24 million in disgorgement, prejudgment interest, and civil penalty
  - As part of the settlement, which was subject to court approval, the defendants consented to entry of final judgments that permanently enjoin Bittrex and co-founder from violating Sections 5, 15(a), and 17A of the Exchange Act and enjoin Bittrex’s foreign affiliate from violating Section 5 of the same Act.
  - "Today’s action, yet again, makes plain that the crypto markets suffer from a lack of regulatory compliance, not a lack of regulatory clarity," said SEC Chair Gary Gensler

SELECTED ENFORCEMENT ACTIONS: CRYPTO

- *In re. Impact Theory* (Aug. 8, 2023). – The SEC settled its first NFT securities action
  - Impact Theory, a media company, sold NFTs that were meant to grant discounts and access to Impact's products, like a blockchain-based avatar creation tool. Broadly interpreting *Howey*, the SEC found that the NFTs were sold as investment contracts based on the company's public statements on social media and online chat rooms about the expected rise in value of the NFTs and its use of profits from sales to develop the company.
  - Charged with violating Sections 5(a) and 5(c) of the Securities Act
  - Without admitting or denying the SEC's findings, Impact settled via cease-and-desist paying a combined total of more than $6.1 million in disgorgement, prejudgment interest, and a civil penalty
  - SEC considered remedial acts undertaken by Impact Theory. Specifically, Impact Theory instituted repurchase programs, with the company offering to buy back KeyNFTs purchased in the offering or on the secondary market. In total, Impact Theory returned approx. $7.7 million to investors

Takeaway: The SEC continues to aggressively seek to address securities violations as they relate to cryptocurrencies and other crypto assets.

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Rules Impacting Private Advisers

Speakers:

- Ruth Delaney, Partner - K&L Gates
- Andrew Feucht, Partner - K&L Gates
- Mark Heine, Partner - K&L Gates
- Matthew Mangan, Partner - K&L Gates

RULES IMPACTING PRIVATE FUND ADVISERS

PRIVATE FUND ADVISER RULES – OVERVIEW

- Scope of Rules
- Preferential Treatment Rule
- Restricted Activities Rule
- Adviser Misconduct Provisions
- Quarterly Statement Rule
- Private Fund Adviser Audits Rule
- Adviser-Led Secondaries Rule
- Written Documentation of All Advisers' Annual Reviews of Compliance Programs
- Transition Period, Compliance Date and Legacy Status
- Current Litigation Challenging Validity and Enforceability of PFAR

SCOPE OF RULES

- All private fund investment advisers (registered and unregistered) are subject to the following new rules:
  - Rule 211(h)(2)-3: Preferential Treatment Rule
  - Rule 211(h)(2)-1: Restricted Activities Rule
- All SEC-registered advisers are subject to the following new rules:
  - Rule 211(h)(1)-2: Quarterly Statement Rule
  - Rule 211(h)(2)-2: Adviser-Led Secondaries Rule
  - Rule 206(4)-10: Audit Rule
  - Rule 206(4)-7: Written Documentation under Compliance Rule
  - These rules do not apply to unregistered advisers and exempt reporting advisers (such as venture capital fund advisers)
- **Offshore Advisers:** The new rules do not apply with respect to the non-U.S. clients (including private funds (even if such funds have U.S. investors)) of an offshore adviser (registered or unregistered)
- **SAF Advisers:** The new rules (except the compliance rule) do not apply to investment advisers with respect to "securitized asset funds" (e.g., CLOs) ("SAFs")

PREFERENTIAL TREATMENT RULE

- Prohibitions on Preferential Redemption and Portfolio Information Rights (Rules 211(h)(2)-3(a)(1) and (2)) (benefit from legacy relief provisions):
  - The rule prohibits a private fund adviser from granting an investor in the fund or in a similar pool of assets (1) preferential redemption rights or (2) preferential information rights (e.g., information regarding portfolio holdings or exposures) that the adviser reasonably expects to have a material, negative effect on other investors in that fund or in a similar pool of assets, unless the same rights are offered to all other investors
- *Exception*: Preferential redemption rights are permitted where such rights are required by applicable law to which the investor, the private fund, or any similar pool of assets is subject
- Rule prohibits other preferential material economic terms unless such terms are disclosed in advance to prospective investors in the private fund (Rule 211(h)(2)-3(b))
  - All preferential terms (regardless of materiality) must be disclosed to other investors in the private fund (Rule 211(h)(2)-3(b))
  - Disclosure to All Investors – Must send written notice of all preferential treatment to other investors in the same private fund: (1) Illiquid Fund – as soon as reasonably practicable following the fund's fundraising period; and (2) Liquid Fund – as soon as reasonably practicable following the investment in the fund by the investor receiving such treatment
- Annual Disclosure – Must provide to current investors comprehensive, annual disclosure of all preferential treatment (including non-economic terms) provided since last annual notice

PREFERENTIAL TREATMENT RULE

- Similar pool of assets means a pooled investment vehicle (other than a registered investment company or a securitized asset fund) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons
  - The definition is designed to capture most commonly used private fund structures (or similar arrangements) and prevent advisers from structuring around the prohibitions on preferential treatment
  - A variety of pools of assets are included in this term regardless of whether they are private funds
  - Requires a facts and circumstances analysis
  - Does not include separate accounts
- *Implications when offshore funds (advised by offshore managers) are the similar pools of assets***.** As a general rule, the SEC has stated that it will not apply the provisions of the rule to the non-U.S. clients (i.e., private funds) of an SEC-registered offshore adviser. However, when the offshore adviser advises private funds that are U.S. clients (such as a Delaware feeder), the consequence is that, notwithstanding the general rule, certain aspects of the preferential treatment rule will apply to the offshore funds to the extent they are “similar pools of assets.”

RESTRICTED ACTIVITIES RULE

- Restricted Activities with Disclosure-Based Exceptions (Rule 211(h)(2)-1) – The rule restricts advisers to a private fund from engaging in the following activities, unless they satisfy certain disclosure requirements:
  - *Regulatory, Examination and Compliance Fees* – May not charge to the private fund any regulatory, examination or compliance fees or expenses of the adviser or its related persons, unless the adviser provides written notice to fund investors of any such fees or expenses and the dollar amount within 45 days after the fiscal quarter end in which the charge occurs
  - *Adviser Tax Clawbacks* – May not reduce the amount of an adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners, unless the adviser provides written notice to fund investors stating the aggregate amounts of the clawback before and after any reduction for actual, potential, or hypothetical taxes within 45 days after the fiscal quarter end in which the clawback occurs
  - *Portfolio Investment Fees and Expenses* – May not charge fees and expenses related to a portfolio investment on a non-pro rata basis when multiple clients advised by the adviser or its related persons invest in the same portfolio company unless (1) the allocation is fair and equitable under the circumstances; and (2) the adviser provides advance written notice to fund investors of the allocation and a description of how it is fair and equitable
- These restrictions do not benefit from the legacy relief provisions

RESTRICTED ACTIVITIES RULE

- Restricted Activities with Consent-Based Exceptions (Rule 211(h)(2)-1) – The rule restricts advisers to a private fund from engaging in the following activities, unless they satisfy certain disclosure and consent requirements:
  - *Government Investigation Fees* – May not charge to a private fund the fees and expenses of a government investigation of the adviser or its related persons unless the adviser requests each fund investor to consent to, and obtains written consent from at least a majority-in-interest of the fund's investors that are not related persons of the adviser
    - Regardless of any disclosure or consent, an adviser may not charge fees and expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for violating the Advisers Act
  - *Borrowing from Related Persons* – May not borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client, unless the adviser: (1) provides to each fund investor a written description of the material terms of, and requests each investor to consent to, such borrowing arrangement; and (2) obtains written consent from at least a majority-in-interest of the private fund's investors that are not related persons of the adviser
- These restrictions do benefit from the legacy relief provisions, except for payment of government investigation fees where the adviser is sanctioned under the Advisers Act

ADVISER MISCONDUCT PROVISIONS

- Adviser Indemnification and Exculpation
  - SEC did not adopt proposal to prohibit an adviser to a private fund from seeking indemnification or exculpation by the fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness
  - However, the SEC reiterated its view that "[a] waiver of an adviser's compliance with its Federal antifraud liability for breach of its fiduciary duty to the private fund or otherwise, or of any other provision of the Advisers Act, or rules thereunder, is invalid under the Act"
    - The SEC retained prior guidance stating that "Whether contractual clauses that purport to limit an adviser's liability (also known as 'hedge clauses' or 'waiver clauses') in an agreement with an institutional client (e.g., private fund) would violate the Advisers Act's antifraud provisions will be determined based on the particular facts and circumstances"
- Fees for Services Not Performed
  - Charging a client fees for unperformed services (including indirectly by charging fees to a portfolio investment held by the fund) where the adviser does not, or does not reasonably expect to, provide such services is inconsistent with an adviser's fiduciary duty

QUARTERLY STATEMENTS

- Rule 211(h)(1)-2 – Requires investment adviser to prepare a clear and concise quarterly statement in plain English that includes:
  - *Fund Table* – Stating for the quarter (1) all compensation, fees and other amounts paid to the adviser or its related persons (by category and dollar amount), (2) all other fees and expenses paid by the fund (by category and dollar amount), (3) any offsets and rebates carried forward, and (4) disclosure and cross-references regarding the methodology for calculating each.
  - *Portfolio Investment Table* – Providing a detailed accounting of all portfolio investment compensation paid to the adviser or its related persons by the fund for the quarter, with separate line items for each category reflecting the total dollar amount, before and after the application of any offsets, rebates, or waivers.
  - *Performance* – Liquid Funds: Annual and average annual returns for 10 years and cumulative returns for current fiscal year-to-date. Illiquid Funds: Gross and net IRR and MOIC, and gross IRR and MOIC for the realized and unrealized portions of portfolio, in each case without subscription facilities.
  - *Consolidated Reporting* – Statement also must include the same information for "similar pools of assets" if "doing so would provide more meaningful information and would not be misleading.
- Scope and Timing Requirements:
  - *Scope* – Reporting applies with respect to private funds with at least two full fiscal quarters of operating results
  - *General Rule* – 45 days after the end of each of the first three fiscal quarters of each fiscal year of the private fund and 90 days after the end of each fiscal year of the fund
  - *Special Rule for Funds of Funds* – 75 days after the end of the first three fiscal quarters of each fiscal year of the private fund and 120 days after the end of each fiscal year **[in either case, unless such a quarterly statement is prepared and distributed by another person]**

MANDATORY PRIVATE FUND ADVISER AUDITS

- Rule 206(4)–10 – Requires private fund advisers to obtain an annual financial statement audit of the private funds they directly or indirectly advise
- Audit must meet certain requirements of the Custody Rule, including:
  - Audit must be performed by an independent public accountant that is registered with, and subject to oversight by, the PCAOB and that meets the standards of independence in Rule 2-01 of Regulation S–X
  - Audit must be an "audit" as defined in Rule 1–02(d) of Regulation S–X
  - Audited financial statements must be prepared in accordance with GAAP
  - Audited financial statements must be delivered to fund investors annually within 120 days of the fund's fiscal year-end and promptly upon liquidation
- For a fund that the adviser does not control and that is neither controlled by nor under common control with the adviser (*e.g.*, an unaffiliated sub-adviser), the adviser would need to take all reasonable steps to cause the fund to undergo an audit that meets these elements

ADVISER-LED SECONDARIES

- Rule 211(h)(2)-2 – Rule requires an investment adviser conducting an "adviser-led secondary transaction" with respect to any private fund that it advises to:
  - Obtain, and distribute to investors in the private fund, a fairness opinion or valuation opinion from an independent opinion provider; and
  - Prepare, and distribute to investors in the private fund, a written summary of any material business relationships the adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider; in each case, prior to the due date of the election form in respect of the adviser-led secondary transaction.
- Adviser-Led Secondary Transactions – "Transactions initiated by the investment adviser or its related persons that offer investors the choice between selling all or a portion of their interests in the private fund and converting and exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or its related persons."
  - Includes transactions involving continuation funds
  - Does not include tender offers
  - Other types of transactions depend on the facts and circumstances
- Fairness Opinion – "*Fairness opinion* means a written opinion stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair."
- Valuation Opinion – "*Valuation opinion* means a written opinion stating the value (as a single amount or a range) of any assets being sold as part of an adviser-led secondary transaction."

WRITTEN COMPLIANCE REPORTS

- Rule 206(4)-7 – Amended to require advisers to review and document in writing, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation
- Amended rule does not prescribe a specific format for the written documentation, instead, allowing an adviser to determine what would be appropriate. SEC cited approvingly that some advisers have chosen to document the annual review in the following ways, but noted that an adviser may choose to document its annual review in other ways:
  - A lengthy written report with supporting documentation
  - Quarterly documentation, aggregated at year end
  - A presentation to the board or another governing body, such as a limited partner advisory committee (LPAC)
  - A short memorandum summarizing the findings
  - Informal documentation, such as a compilation of notes throughout the year.
- SEC stated that the required written documentation of the annual review under the compliance rule is meant to be made available to the SEC and the SEC staff and therefore should promptly (within 24 hours absent unusual circumstances) be produced upon request

TRANSITION PERIOD, COMPLIANCE DATE AND LEGACY STATUS

EFFECTIVE DATE:	NOVEMBER 13, 2023
Compliance dates as follows:	
Documenting annual review in writing	November 13, 2023
Adviser-led secondaries, preferential treatment and restricted activities for large advisers (>1.5B RAUM)	September 14, 2024
Adviser-led secondaries, preferential treatment and restricted activities for small advisers (<1.5B RAUM)	March 14, 2025
Quarterly statements and annual audits	March 14, 2025

- Legacy status provided as follows:
  - Prohibitions aspect (but not disclosure provisions) of the preferential treatment rule, which prohibits advisers from providing certain preferential redemption rights and information about portfolio holdings
  - Consent (but not disclosure) requirements of the restricted activities rule, which restrict an adviser from borrowing from a private fund and from charging for certain investigation fees and expenses without consent
  - Legacy status provisions apply to governing agreements that were entered into prior to the compliance date if the rule would require the parties to amend such an agreement and only where the private fund had commenced operations as of the compliance date
- Legacy status does not permit advisers to charge for fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Advisers Act
- **Ongoing litigation challenging the validity and enforceability of PFAR**

AMENDED RECORDKEEPING REQUIREMENTS

- PFAR amended the Advisers Act recordkeeping requirements to include:
  - Any notice required regarding preferential treatment under Rule 211(h)(2)–3 as well as a record of each addressee and the corresponding date(s) sent
  - A copy of any quarterly statement distributed pursuant to Rule 211(h)(1)–2, along with a record of each addressee and the corresponding date(s) sent
  - All records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any quarterly statement
  - For each private fund client: (i) a copy of any audited financial statements prepared and distributed pursuant to Rule 206(4)–10, along with a record of each addressee and the corresponding date(s) sent; or (ii) a record documenting steps taken by the adviser to cause a private fund client that the adviser does not control, is not controlled by, and with which it is not under common control to undergo a financial statement audit pursuant to Rule 206(4)–10
  - Documentation substantiating the adviser's determination that a private fund client is a liquid fund or an illiquid fund for purposes of performance reporting in the quarterly statement pursuant to Rule 211(h)(1)–2
  - A copy of any fairness opinion or valuation opinion and material business relationship summary distributed pursuant to Rule 211(h)(2)–2, along with a record of each addressee and the corresponding date(s) sent
  - A copy of any notification, consent or other document distributed or received pursuant to the restricted activities provisions of Rule 211(h)(2)–1, along with a record of each addressee and the corresponding date(s) sent for each such document distributed by the adviser


FORM PF

AMENDMENTS TO FORM PF – KEY CHANGES

- Amendments to Form PF Approved May 3, 2023
  - Significantly Expands the Scope of Form PF Reporting
- Impacted Advisers
  - “Current” Reporting for Large Hedge Fund Advisers
  - Quarterly Reporting for Private Equity Fund Advisers
  - Additional Reporting For Large Private Equity Fund Advisers
- Compliance Dates
  - Event Reporting: December 11, 2023
  - Other Amendments: June 11, 2024

CURRENT REPORTING REQUIREMENTS

- "Large" Hedge Fund Advisers
  - Advisers w/ $1.5b in AUM attributable to hedge funds
- Reporting Events Include:
  - Extraordinary investment losses
  - Certain margin events
  - Counterparty default
  - Material changes in prime broker relationships
  - Operations events
  - Large withdrawal and redemption requests
- Must file as soon as practicable, no later than 72 hours

QUARTERLY REPORTING REQUIREMENTS

- Private Equity Fund Advisers
  - Quarterly reporting requirements apply to all private equity fund advisers
- Must report within 60 days of each quarter-end:
  - Completion of an adviser-led secondary transaction
  - Investor election to remove a fund's adviser or GP, terminate investment period or terminate the fund

REPORTING FOR LARGE PE ADVISERS

- "Large" Private Equity Fund Advisers
  - Advisers w/ $2b in AUM attributable to PE funds
- New information required in annual updates:
  - implementation of general partner and certain significant limited partner clawbacks
  - details about a fund's investment strategies
  - information about fund-level borrowings
  - granular information about events of default
  - information about institutions providing bridge financing
  - information about a fund's greatest country exposures


PROPOSED
SAFEGUARDING RULE

SAFEGUARDING RULE – KEY CHANGES

- Would Rescind and Replace the "Custody Rule" (Rule 206(4)-2) with the "Safeguarding Rule" (New Rule 223-1)
  - Proposal Issued: February 15, 2023
  - Original Comment Deadline: May 8, 2023
  - Comment Period Re-Opened: August 23, 2023 (due to PFAR audit requirement)
  - Second Comment Deadline: October 30, 2023
  - RegFlex Agenda Status: Prior to re-opening of comment period, final action was scheduled by October 2023. Updated RegFlex Agenda expected in late 2023/early 2024
- Expanded Scope of New Rule
  - Broadens scope of client assets covered by the rule to include all client assets, not limited to "funds and securities"
  - Broadens scope of activities covered by the rule to include discretionary authority to trade as conferring custody, reversing a long-standing SEC position
- More Burdensome Qualified Custodian Requirements
  - Expands and introduces complexity to the qualified custodian's role by, among other things, imposing a new "possession and control" requirement for qualified custodians and requiring advisers to enter into written agreements with custodians and to obtain reasonable assurances regarding specified minimum custodial protections

SAFEGUARDING RULE – KEY CHANGES

- Assets Unable to be Maintained with a Qualified Custodian
  - Limits the utility of the qualified custodian exception for privately offered securities, but expands it to include physical assets (*e.g.*, precious metals, physical commodities, and real estate)
  - Numerous and burdensome new conditions to rely on the exception
- Additional Requirements for Segregation of Client Assets
  - Client assets over which adviser has custody must (1) be titled or registered in the client's name or otherwise held for the benefit of that client, (2) not be commingled with the adviser's assets or its related persons' assets, and (3) not be subject to any right, charge, security interest, lien, or claim in favor of the adviser, its related persons, or its creditors, except to the extent agreed to or authorized in writing by the client
- Investment Adviser Delivery of Notice to Clients
  - Notice must continue to include the qualified custodian's name, address, and the manner in which the investments are maintained, but also would be required to include the custodial account number

SAFEGUARDING RULE – KEY CHANGES

- Amendments to the Surprise Examination Requirement
  - Imposes new requirement that an adviser must reasonably believe that the written agreement with the accountant performing the exam has been implemented (*i.e.*, that the accountant is capable of, and intends to, comply with the agreement and its obligations thereunder, including Form ADV–E filing and notification requirements when required)
- Additional Exceptions from Surprise Exam Requirement
  - Provides an exception when the adviser's sole reason for having custody is because it has discretionary authority, subject to conditions
  - Provides an exception where the adviser is acting according to a "standing letter of authorization"
- Expanded Availability of Audit Provision Beyond Pooled Vehicles
  - Proposed rule would make the audit provision available with respect to any advisory client entity whose financial statements are able to be audited in accordance with the rule, including pension plans, retirement plans and college saving plans (529 plans)

SAFEGUARDING RULE – KEY CHANGES

- Significantly Expanded Adviser Recordkeeping Requirements
  - More detailed and broader scope of records of trade and transaction activity and position information for each client account than the existing requirements for such records
- Significantly Expanded Form ADV Disclosure Requirements
  - More detailed Form ADV disclosure regarding, among other things, (1) the amount of client assets and number of clients falling into each custody category, (2) qualified custodians, (3) independent public accountants performing audits and surprise exams, and (4) exceptions being relied upon by the adviser
- Existing Staff No-Action Letters and Other Staff Statements
  - SEC staff is reviewing no-action letters and other guidance under the custody rule to determine whether any (or any portions thereof) should be withdrawn in connection with any adoption of the proposal
- Very Short Transition Period and Compliance Date
  - One year transition period (with a longer 18-month period for advisers with no more than $1 billion in regulatory assets under management)

K&L GATES

ESG Developments for Managers

Speakers:

- Sasha Burstein, Partner - K&L Gates
- Ruth Delaney, Partner - K&L Gates
- Margaret Niles, Partner - K&L Gates

OVERVIEW

1. Strong demand for ESG investments
2. Managers rushing to the space
3. Proposed SEC ESG disclosure rules
4. DOL ESG Rule
5. Red states begin passing anti-ESG legislation
6. Managers react to market split with demand from some investors for ESG strategies but other investors pulling away from investments with the purpose to further ESG initiatives

DEVELOPMENTS IN THE ESG SPACE

- Proposed SEC ESG disclosure rules
  - Enhanced ESG disclosure
    - Integration Funds, ESG Focused Funds, Impact Funds
- The States
  - Concern that state assets are being used to promote ESG goals instead of providing investment returns
- DOL ESG Rule

SEC PROPOSAL: ESG DISCLOSURE AND REPORTING FOR INVESTMENT ADVISERS

- The SEC's proposal would require investment advisers to include specific disclosures in their Form ADV, Part 2A regarding:
  - Their ESG strategy
  - The criteria and methodology used to evaluate, select or exclude investments based on ESG factors
  - Material relationships with any related person ESG consultants or other service providers
- Comparable disclosure and reporting requirements would apply in connection with separately managed accounts, private funds and wrap fee programs

PROPOSED ESG REFORMS FOR FUNDS

- Proposed New ESG Taxonomy and Required Disclosures for funds

Type of Fund	Definition
Integration Funds	Funds that **"consider"** one or more ESG factors alongside non-ESG factors in their investment decision-making process, but where such ESG factors are not dispositive in the funds' investment decisions
ESG-Focused Funds	Funds that consider one or more ESG factors as significant or primary factors in selecting investments or in engagement with portfolio companies
Impact Funds	Subset of ESG-Focused Funds that seek to achieve one or more specific ESG impacts

- Funds would be subject to enhanced disclosure requirements for prospectuses and shareholder reports depending on the level of ESG focus

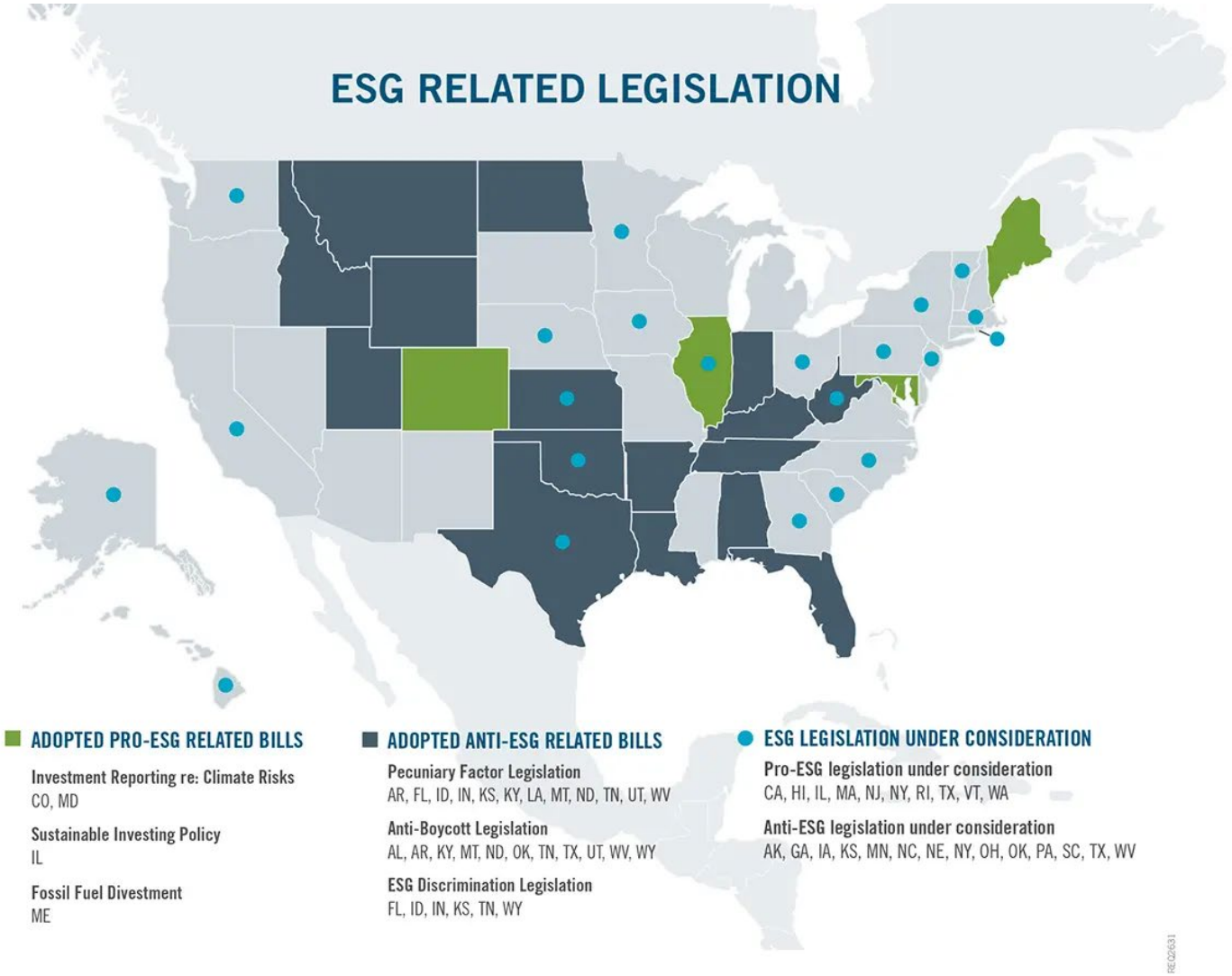
DOL ESG Rule

- DOL released a final rule in December 2022 (that went into effect January 2023) that addresses fiduciary duties when considering ESG factors in selecting investments
- The new rule overwrites a Trump-era rule that DOL viewed as having a chilling effect on fiduciaries considering ESG factors in connection with investments for ERISA investors
- The core principles for fiduciary decision-making with respect to investing have not changed
    - ERISA's duties of prudence and loyalty require fiduciaries to focus on relevant risk-return factors and not subordinate the interests of plan participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan
    - ESG factors should be evaluated like any other potential investment factor

STATES PASS ESG LEGISLATION

- Some states propose pro-ESG legislation
  - Investment managers must consider ESG as a risk factor
  - Require investment manger to report on ESG factors considered and obtain client consent to such
    - Subject to some litigation
- Some states adopt anti-ESG legislation
  - Generally relate to:
    - Who states can hire or
    - How state money must be managed
  - Anti-ESG Legislation Case Study

THE STATES


ESG RELATED LEGISLATION
ADOPTED PRO-ESG RELATED BILLS
Investment Reporting re: Climate Risks
CO, MD
Sustainable Investing Policy
IL
Fossil Fuel Divestment
ME
ADOPTED ANTI-ESG RELATED BILLS
Pecuniary Factor Legislation
AR, FL, ID, IN, KS, KY, LA, MT, ND, TN, UT, WV
Anti-Boycott Legislation
AL, AR, KY, MT, ND, OK, TN, TX, UT, WV, WY
ESG Discrimination Legislation
FL, ID, IN, KS, TN, WY
ESG LEGISLATION UNDER CONSIDERATION
Pro-ESG legislation under consideration
CA, HI, IL, MA, NJ, NY, RI, TX, VT, WA
Anti-ESG legislation under consideration
AK, GA, IA, KS, MN, NC, NE, NY, OH, OK, PA, SC, TX, WV

ESG ABROAD

- **European Union:** The Sustainable Finance Disclosure Regulation requires fund and asset managers to make certain prospectus, website and other disclosures regarding how sustainability is integrated.
- **United Kingdom:** The UK Financial Conduct Authority has set forth rules and guiding principles impacting asset managers that wish to make ESG-related claims.
- **Hong Kong:** The Hong Kong Securities and Futures Commission subjects funds that consider ESG or sustainability factors in their investment process to disclosure and reporting requirements.
- **Japan:** The Financial Services Agency of Japan requires asset managers to make certain disclosures and implement organization, operational and due diligence measures with respect to publicly offered ESG-focused investment trusts.
- **Others:** See K&L Gates Global ESG Survey

K&L GATES

LP Trends

Speakers:

- Sasha Burstein, Partner - K&L Gates
- Andrew Feucht, Partner - K&L Gates
- Mark Heine, Partner - K&L Gates
- Margaret Niles, Partner - K&L Gates

CONTINUATION FUNDS

- A.k.a. secondaries or GP-led secondaries
- Increasingly common
  - One UBS survey indicates expected 2023 volume up from 2022
  - Most fund documents in current market provide for continuation funds
  - But terms and approaches still vary considerably for each manager and each deal
- ILPA information is that most LPs sell
  - Insufficient time to evaluate
  - Acknowledge that GP has better information than LPs

LP CONSIDERATIONS – TERMS IN LPA

- Market is still in flux, but most provisions:
  - Allow each LP to elect to sell or "roll"
    - Rolling LPs may be offered new terms or status quo terms
    - LPs may be offered opportunity to acquire additional interests in the company
  - Require LPAC review and approval of the offer
  - Provide limited time for LPs to decide or do not specify timing
- Provisions generally maximize flexibility for GP

LP CONSIDERATIONS – CONTINUATION FUND TERMS

- Multiple documents may be involved -- consider:
  - Terms of main fund LPA and side letter
    - Note: LPs should not assume side letter rolls to the new vehicle
  - Transaction documents for rolling LPs and new investors to acquire interests in the continuation fund
  - Continuation fund's LPA
    - New terms on management fee and carried interest
    - May be limited LP protections such as key person, bad acts
  - Portfolio company information

LP CONSIDERATIONS – CONTINUATION FUND TERMS, CONT.

- Key issues: Economics
  - Pricing!
    - New SEC rule requires fairness opinion or valuation opinion and information on relationship of GP to opinion provider
    - Third-party participation
  - Fees and carry
    - GP crystallizes carry for selling LPs – does GP roll that value into the continuation fund?
  - Allocation of costs among main fund LPs (rolling and redeeming) and third party “new” money
- LP protection issues
  - Waiver of conflicts of interest; possible waiver of claims generally?
  - Anti-dilution protection for rolling LPs

ILPA GUIDANCE

- Rolling LPs should be offered a “true status quo” option
  - No change in the management fee base
  - No increase to the carried interest rate, preferred return hurdle
  - No crystallization of carried interest
  - Side letters apply to the new vehicle
- LPs should prepare to deal with offers and investments in continuation funds
  - Tracking roll vs. sell decisions
  - Track continuation fund performance
  - Implement continuation fund questions into due diligence process

PRIVATE CREDIT OVERVIEW

- Significant growth in demand for private credit strategies since the global final crisis
- The size of the private credit market at the start of 2023 was approximately $1.4 trillion*, compared to $875 billion in 2020, and is estimated to grow to $2.3 trillion by 2027**
- Investors have increasingly added private credit to their portfolios as a higher-yielding alternative to traditional fixed-income strategies

* *Bloomberg;* January 2023

** *Preqin;* January 2023

BENEFITS OF PRIVATE CREDIT

- Current income: Private credit generally offers the possibility for current income from contractual cash flows (i.e., interest payments and fees).
- Historically lower loss rates: Private credit has demonstrated lower default rates relative to public credit over time.
- Diversification: Private credit has been less correlated with public markets than other asset classes, such as equities and bonds.
- Higher Returns and Lower Volatility: Direct lending has provided higher returns and lower volatility compared to both leveraged loans and high-yield bonds.*

* *Morgan Stanley: Understanding Private Credit*

PRIVATE CREDIT FUND TRENDS

According to 2023 industry trends study that surveyed 40 private credit managers managing $800 billion in private credit investments.

- Investors are increasingly seeking customized investment structures
  - 80% of respondents manage capital through a mixture of commingled funds and other vehicles
  - 95% of respondents stated that they offer managed account structures for single investors
  - 69% of respondents expect demand for co-investment to increase
- Demand for liquidity supporting permanent capital allocations
  - Increase in evergreen or hybrid vehicles which combine elements of open and closed-ended fund structures
- Growth of retail capital in private credit
  - 41% of respondents currently have retail clients and 66% stated that they will or are considering raising capital from retail clients for upcoming fund offerings

PRACTICAL CHALLENGES FOR CO-INVESTING

- Timing is always short – why?
  - GP challenge to allocate the co-investment opportunity – sizing, participation of strategic investors
  - To some extent by design – limited opportunity for LPs to negotiate co-investment fund terms
- Staff may lack expertise for diligencing co-investment opportunities
  - Many institutional investors primarily invest through funds; they pick managers, not deals
  - GPs do not offer assurances – LPs are “on their own”
- Expenses are often required to be paid in addition to investment amount – potential issue of unlimited liability

PRACTICAL CONSIDERATIONS FOR CO-INVESTING, CONT.

- To get around the challenges, some investors set up co-investment SMAs
  - Typically, LP has no assurances that the SMA will be given opportunities
  - SMA will have a GP that has fiduciary duties to the LP in offering and diligencing opportunities
  - LP might have opt-out arrangement rather than opt-in
  - Even if no fees/carry, GP has readily-available funds

PRACTICAL CONSIDERATIONS FOR CO-INVESTING, CONT.

- Co-investments are typically structured through a vehicle managed by the GP
  - There may be multiple layers of vehicles if investor has SMA
  - Little, if any, control by co-investors
    - May lack independent right to terminate or remove GP
  - Key is to maximize alignment with main fund – same terms, timing, expenses, anti-dilution rights

TOP LP CONCERNS IN NEGOTIATING INVESTMENTS IN PRIVATE FUNDS

- Reporting/transparency
  - Access to additional information
- Fiduciary duties/conflicts of interest
  - Allocation of opportunities – co-investment rights
  - "Sole discretion" language
- Expenses
  - Organizational expenses keep rising
  - Additional charges/fees to GP or affiliates that are not offset against management fees
  - Fund bears a lot of overhead, some of which is paid to GP-affiliated service providers
- No fault rights
- MFN rights – seeing all other side letter terms
- Role of fund counsel
  - Disconnect between fund counsel and the GP
  - Counsel wants to protect its terms
  - Lack of budget constraints


Thank You!

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