SEC Exams and Enforcement Trends

Speakers

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SEC Rulemakings and Other New Rules

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SEC Rulemakings: Vacated Rule

Private Fund Adviser Rules

The Fifth Circuit Court of Appeals vacated these rules on June 5, 2024, ruling that the SEC exceeded its statutory authority under Sections 206(4) and 211(h) of the Investment Advisers Act of 1940.

- The vacated rules included:
  - Preferential Treatment Rule: Restricted preferential treatment for certain investors.
  - Restricted Activities Rule: Limited specific activities deemed harmful to investors.
  - Quarterly Statement Rule: Mandated quarterly disclosures to investors.
  - Adviser-Led Secondaries Rule: Imposed requirements on secondary transactions led by advisers.
  - Audit Rule: Required annual audits for private funds.
  - Compliance Documentation Amendments: Amendments requiring written annual compliance documentation were also invalidated, although they remain recommended best practices.

Broader Implications

- Following the Fifth Circuit's decision, there are concerns about the SEC's ability to propose new rules or amend existing ones without clear statutory authority.
- In addition to the invalidation of these rules, shortly thereafter, on June 27, 2024, the Supreme Court ruled against the SEC's internal system for pursuing civil fraud penalties, further constraining the agency's enforcement capabilities (SEC v. Jarkesy) . This decision emphasized defendants' rights to a jury trial, which could reshape how the SEC conducts its enforcement actions.
  - Following the ruling, if settlement is not reached in connection with matters arising from alleged securities fraud, the case will have to go before a federal judge and a jury (and not before ALJ’s operating within the SEC).

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SEC Rulemakings: Abandoned?

Safeguarding Rule

The SEC's proposed safeguarding rule, which aimed to enhance protections for investors in private funds, faced substantial criticism and legal challenges. Following a ruling from the Fifth Circuit Court of Appeals that struck down the SEC's authority to enforce certain private fund regulations, the agency has not indicated plans to reintroduce similar rules at this time.

- Custody Rule compliance expected to remain a focus area.

SEC Rulemakings: Regulation 13D-G

Regulation 13D-G

- In 2023, the SEC amended the rules governing beneficial ownership reporting under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934, including the filing requirements for reports on Schedule 13G that went into effect beginning September 30, 2024.

Initial Schedule 13D and G filing

- Generally, 5 business days after acquiring more than 5% of beneficial ownership. Schedule 13G filers that are qualified institutional investors, or exempt investors, can file 45 days after the end of the calendar quarter in which the 5% threshold is exceeded, and 5 business days after first month in which 10% threshold is crossed.

Amended Filings

- Schedule 13D. 2 business days after the date on which a material change occurs.
- Schedule 13G: Passive Investors:
  - 45 calendar days after the end of the calendar quarter in which any material change occurred (not including changes in percentage ownership due to fluctuations in number of shares outstanding).
  - 2 business days after acquiring more than 10% beneficial ownership and within 2 business days thereafter after beneficial ownership increases or decrease by 5%.

SEC Rulemakings: Regulation 13D-G

- **Schedule 13G**: Qualified institutional investors:
  - 45 calendar days after the end of the calendar quarter in which any material change occurred (not including changes in percentage ownership due to fluctuations in number of shares outstanding).
  - 5 business days after acquiring more than 10% beneficial ownership and within 5 business days thereafter after beneficial ownership increases or decrease by 5%.

Filing deadlines. The SEC shortened filing deadlines for Schedules 13D and 13G and moved most deadlines to a "business day" standard. The EDGAR cut-off time for these filings was extended from 5:30 PM to 10 PM Eastern Time.

Amendment filing. Amendments to Schedule 13G must be filed only if a “material change" occurs. The previous rule required an amendment for "any change" in previously reported facts.

Structured data. Filings must use a structured, machine-readable XML-based language.

Materiality concept. Funds must establish a process to assess the materiality of developments, such as transactions involving public company securities.

Group Status. Though SEC declined to codify the definition of a “group” as proposed, it issued guidance the adopting release confirming its views.

FINCEN AML Rule

FinCEN Finalizes Anti-Money Laundering Program Rule For Investment Advisers

- On August 28, 2024, the Financial Crimes Enforcement Network (FinCEN), issued a Final Rule, imposing new anti-money laundering (AML) and countering the financing of terrorism (CFT) program requirements on RIAs and ERAs.

Compliance Deadline: The Final Rule has a compliance date of January 1, 2026. Investment advisers must implement their AML/CFT compliance programs by this date.

Scope of Applicability

- **Covered Entities**: The Final Rule applies to RIAs and ERAs, including those based outside the U.S. but not those relying on the Foreign Private Adviser Exemption. However, it excludes certain mid-sized and multi-state advisers, as well as those without assets under management (AUM).
- **Private Funds**: Investment advisers must include private funds they advise in their AML/CFT programs, requiring risk assessments of investors and potentially collecting identifying information about them.

FINCEN AML Rule

The Final Rule requires RIAs and ERAs to adopt a written AML compliance program that includes the following minimum elements:

- Internal policies, procedures, and controls reasonably designed to prevent the RIA or ERA from being used for money laundering, terrorist financing, or other illicit finance activities.
- Designation of one ore more AML compliance officers;
- Provision of ongoing AML training for appropriate personnel;
- Independent testing of the program's effectiveness; and
- Risk-based procedures for conducting ongoing customer due diligence to (1) understand the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and (2) identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.

Reporting Obligations

- Suspicious Activity Reports (SARs): Advisers will be required to file SARs and comply with other reporting obligations, which is a significant shift from previous practices where such requirements were not mandated.

Independent Testing.

- There is a requirement for independent testing of the AML program, which may necessitate hiring external auditors unless internal personnel can perform this function independently. Internal personnel performing the testing would need to be independent from the AML program.

FINCEN AML Rule

Delegation of Responsibilities

The Final Rule permits advisers to contractually delegate the implementation and operation of some or all of their AML programs to third parties, such as fund administrators. However, the adviser will remain fully responsible and legally liable for compliance with the Final Rule's requirements. In addition, the adviser must (1) ensure that FinCEN and the SEC are able to obtain information and records relating to the AML program; and (2) identify and document procedures to address its risk profile.

- An adviser that delegates any aspect of its AML program to a third party must undertake reasonable steps to ensure the third party conducts such procedures effectively. A certification is not sufficient. Examples of oversight steps to consider include pre-engagement due diligence, a written agreement with covenants (including requirements to adhere to reasonably designed policies and reporting to the adviser if deficiencies are identified), and/or periodic monitoring of the delegate’s compliance.

Takeaway: Investment advisers should begin preparations to meet these requirements well in advance of the compliance deadline to ensure effective implementation of their AML/CFT programs.

FINCEN/SEC Joint Proposal: CIP Rule

FinCEN and SEC Jointly Propose Customer Identification Program (CIP) Rule

- If adopted as proposed, the proposed rule would require RIAs and ERAs to implement reasonable procedures to require customer identity verification. Advisers will be able to delegate their obligations and responsibilities to other financial institutions.
- The scope of the required program is limited to an adviser’s direct customers. The proposed rule defines “customer” for purposes of the obligations as a person – including a natural person or a legal entity – who opens a new account with an investment adviser (i.e., the person identified as the accountholder). The proposed rule would not require advisers to look through a trust or similar account to its beneficiaries.
- As a result, RIAs and ERAs generally would not be required to identify or verify persons who hold a 25 percent or more beneficial ownership interest in their direct customers. Private funds advised by RIAs or ERAs would be considered the “customer” under the Proposed Rule and advisers would not need to apply the CIP to the funds’ underlying investors.

FINCEN/SEC Joint Proposal: CIP Rule

General Requirements:

- RIAs and ERAs would be required to establish, document and maintain written CIPs appropriate for the respective adviser's size and business.
- The CIP must be a part of the adviser's AML/CFT.

Identity Verification Procedures:

- The CIP must include risk-based procedures to verify the identity of each customer to the extent reasonable and practicable. Such procedures must enable the adviser to form a reasonable belief that it knows the true identity of each customer.
- <u>Customer Information Required:</u>
    - RIAs and ERAs must obtain, at minimum, the following information from a customer prior to opening an account:
        - Name
        - Date of birth or date of formation
        - Address
        - Identification number
- <u>Customer Verification:</u>
    - The CIP must contain risk-based procedures to verify the identity of each customer through either documentary (e.g., driver's license or documents of formation) or non-documentary (use of an account verification database or reference checks) within a reasonable time before or after the customer's account is opened.

FINCEN/SEC Joint Proposal: CIP Rule

  - The CIP also must address situations where the adviser cannot verify the true identity of a customer that is not an individual using documentary or non-documentary methods.
- Lack of Verification:
  - The CIP must include procedures for responding to circumstances in which the adviser cannot form a reasonable belief that it knows a customer's true identity.

Recordkeeping:

- The CIP must include procedures for making and maintaining a record of all information obtained pursuant to the CIP minimum requirements, including, at minimum, (i) all identifying information obtained about a customer; (ii) a description of any key document relied on as part of documentary verification; (iii) a description of the methods and results of any measures undertaken to verify a customer's identity; and (iv) a description of the resolution of each substantive discrepancy discovered when verifying identifying information.
- Records must be retained for five years after an account is closed or after a record is made, as applicable.

Comparison with Government Lists

- The CIP must include reasonable procedures to determine whether a customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency.

FINCEN/SEC Joint Proposal: CIP Rule

Customer Notice

- The CIP must include procedures for providing customers with adequate notice that the adviser is requesting information to verify the customer's identity.
- Notice is deemed "adequate" under the Proposed Rule if the adviser generally describes the identification requirements of the Proposed Rule and provides notice in a manner reasonably designed to ensure that a prospective customer is able to view the notice, or is otherwise given notice, before opening an account.

Reliance on Another Financial Institution

- The CIP may include procedures specifying when an adviser will rely on other financial institutions' CIP procedures, which is permitted when the following conditions are met:
  - The other financial institution is subject to AML compliance program requirements and is regulated by a federal functional regulator.
  - The other financial institution enters into a contract with the adviser requiring it to certify annually that it has implemented an AML program and will perform (or its agent will perform) the specified requirements of the CIP.
  - Such reliance is reasonable under the circumstances.

Corporate Transparency Act

The CTA is part of the Anti-Money Laundering Act of 2020, which itself is part of the National Defense Authorization Act

- The CTA became law on January 1, 2021 after Congress overrode President Trump's veto.
- FinCEN established the effective date of the CTA as January 1, 2024. See, 31 C.F.R. § 1010.380
  - Newly formed US entities (or non-US entities registering to do business in the US) from January 1, 2024 until December 31, 2024, must comply with the provisions of the CTA within 90 days after such entity's initial formation (or registration) filing.
  - Newly formed US entities (or non-US entities registering to do business in the US) starting January 1, 2025, must comply with the provisions of the CTA within 30 days after such entity's initial formation (or registration) filing.
  - US Entities existing on December 31, 2023 (or non-US entities) already registered to do business in the US) prior to January 1, 2024 must comply with the CTA by January 1, 2025.

Corporate Transparency Act

- The CTA requires Reporting Companies to provide information about the identity of their Beneficial Owners and, for newly formed Reporting Companies, Company Applicants to FinCEN.
  - Starting January 1, 2024, newly formed Reporting Companies must provide both Beneficial Owner **and** Company Applicant information to FinCEN.
  - Existing Reporting Companies need to only provide Beneficial Owner information to FinCEN by January 1, 2025.
  - To the extent any of the information reported to FinCEN changes, the Reporting Company must file an update within 30 calendar days after the change.
- A “reporting company” is defined to mean a domestic or foreign reporting company, as follows:
  - A “domestic reporting company” means any entity that is (i) a corporation, (ii) a limited liability company or (iii) created by the filing of a document with a secretary of state or any similar office under the law of a state or Indian tribe.
  - A “foreign reporting company” means any entity that is (i) a corporation, limited liability company or other entity, (ii) **formed under the law of a foreign country** and (iii) **registered to do business in the United States** by the filing of a document with a secretary of state or any similar office under the law of a state or Indian tribe.

Corporate Transparency Act

Reporting Companies: The CTA includes 23 categories of exemptions from the definition of “reporting company” from the CTA for entities already generally subject to substantial federal or state regulation under which beneficial ownership may be known, such as certain entities registered with the Securities and Exchange Commission (SEC).

Examples of Exempt Entities:

- SEC-registered RIAs (and controlled GPs, generally).
- Venture Capital Fund Advisers can also be exempt from BOI reporting, but only if they meet specific criteria outlined in Section 203(l) of the Advisers Act and file Form ADV with the SEC.
- Pooled investment vehicles that (i) would rely on Section 3(c)(1) and 3(c)(7) of the Investment Company Act and (ii) are identified by the adviser in its Form ADV (or will be so identified in its next update).

Not Exempt:

- State-Registered RIAs: Must report beneficial ownership information (BOI) by January 1, 2025, if established before 2024; new RIAs have 90 days to file after formation.
- Exempt Reporting Advisers other than Venture Capital Fund Advisers.
- Private funds advised by state-registered RIAs and non-VC ERAs.

FORM PF

- Significant amendments to Form PF requiring, among other things, event-based reporting, took effect in December 2023.
- In February 2024, the SEC and CFTC jointly adopted further amendments to Form PF.
- The latest amendments generally increase the amount of disclosure required for all private fund advisers that report on Form PF
  - Large hedge fund advisers and advisers with complex fund structures will see the biggest impact.
  - The amendments impact how large hedge fund advisers report investment exposures, borrowing and counterparty exposure, market factor effects, currency exposure, turnover, country and industry exposure, central clearing counterparty reporting, risk metrics, investment performance by strategy, portfolio liquidity, and financing and investor liquidity.
- The effective date for the most recent amendments is March 12, 2025.

SEC Exam Priorities and Risk Alerts

2025 SEC Examination Priorities

Key Focus Areas For Investment Advisers

- **Adherence to Fiduciary Standards of Conduct**: The SEC will prioritize examinations to ensure that investment advisers fulfill their fiduciary obligations, specifically the duty of care and duty of loyalty.
  - Adviser's duty to, at all times, serve the best interests of its clients and not place its own interests ahead of the interests of its clients.
  - Eliminate or make full and fair disclosure of all conflicts of interests in order for clients to make informed consent to the conflict.
- **Effectiveness of Adviser's Compliance Program**: The SEC will assess the effectiveness of compliance programs within advisory firms, particularly focusing on how these programs address fiduciary duties and ensure adherence to standards of conduct.
  - Fundamental part of the examination process.
  - Includes an evaluation of the core areas of an adviser's compliance program.
  - Include an analysis of an adviser's annual compliance reviews.
  - May go into greater depth depending on the particular adviser's practices or products, for example, if clients invest in difficult-to-value assets, such as commercial real estate, exams may have a heightened focus on valuation.

2025 SEC Examination Priorities

Examinations of Private Fund Advisers.

- ***Whether disclosures are consistent with actual practices and if met its fiduciary obligations in times of market volatility, including whether a private fund is exposed to interest rate fluctuations.***
  - Examples commercial real estate, illiquid asset strategies, and private credit.
  - Focus on advisers to private funds that are experiencing poor performance and significant withdrawals and/or are leveraged or hold difficult-to-value assets.
- ***The accuracy of calculations and allocations of private fund fees and expenses (both fund-level and investment-level).***
  - With respect to valuation of illiquid assets, calculation of post commitment period management fees, offsetting of fees and expenses, and the adequacy of disclosures.

2025 SEC Examination Priorities

- ***Disclosure of conflicts of interests and risks, and adequacy of policies and procedures.***

For example, with respect to (i) use of debt, fund-level lines of credit, investment allocations, adviser led secondary transactions, transactions between fund(s) and others; (ii) investments held by multiple funds; and (iii) use of affiliated service providers.

- *Compliance with recently adopted SEC rules, including amendments to Form PF, and the updated rules that govern investment adviser marketing, to assess whether advisers have established adequate policies and procedures and whether their actual practices conform to them.*

2025 SEC Examination Priorities

- **Examinations of Newly Registered Advisers**: There is a specific emphasis on examining newly registered advisers and those who have not been recently evaluated. This approach aims to ensure that all advisers, regardless of their experience level, maintain high compliance standards from the outset.
- **Emerging Risks and Technologies**: The SEC's priorities also reflect a growing concern about how emerging technologies, such as artificial intelligence, impact compliance with fiduciary standards. Advisers will be scrutinized for how they integrate these technologies into their practices while still adhering to their fiduciary duties.

2025 SEC Examination Priorities

Risk Areas Impacting Various Market Participants

A. Information Security and Operational Resiliency
   1. Cybersecurity
   2. Regulation S-ID and Regulation S-P
   3. Shortening of the Settlement Cycle

B. Emerging Financial Technologies

C. Crypto Assets

Division of Examinations Risk Alerts

Title	Date
Registered Investment Companies: Review of Certain Core Areas and Associated Documents Requested	Nov. 4, 2024
Broker-Dealers: Staff Assessment of Risks, Scoping of Examinations, and Requesting of Documents	June 5, 2024
Initial Observations Regarding Advisers Act Marketing Rule Compliance	April 17, 2024
Shortening the Securities Transaction Settlement Cycle	March 27, 2024
Observations Related to Security-Based Swap Dealers	Jan. 10, 2024
Investment Advisers: Assessing Risks, Scoping Examinations, and Requesting Documents	Sept. 6, 2023
Observations From Anti-Money Laundering Compliance Examinations of Broker-Dealers	July 31, 2023
Examinations Focused on Additional Areas of the Adviser Marketing Rule	June 8, 2023

Key Focus Areas and Notable Enforcement Actions

Selected Enforcement Actions

- Recent and Ongoing Sweeps
  - Off-Channel communications/recordkeeping
  - Marketing rule
  - Beneficial ownership reporting
- Whistleblower protection rules
- Custody rule
- Hedge Clauses
- Conflicts of Interest-related actions
- MNPI/Insider trading/Shadow Trading
- Use of Advisory Committees/LPACs
- Exempt Reporting Advisers
- Use of an Unregistered Broker

Selected Enforcement Actions: Off-Channel Communications Sweeps

During 2024, the SEC charged 22 broker-dealers, 20 dually-registered broker-dealers and investment advisers, 9 affiliated investment advisers, and 5 standalone investment advisers for failures by the firms and their personnel to maintain and preserve electronic communications on personal devices.

- Combined penalties exceeded $500 million, with individual penalties of up to $50 million.
- Several firms self-reported their violations and paid significantly lower civil penalties (and in one case - Qatalyst Partners - no monetary penalty).
- Commissioners Peirce & Uyeda objected to the penalties and undertakings in most cases and issued a statement following the Qatalyst Partners settlement urging the Commission to reconsider its current approach to the off-channel communications issue.

Selected Enforcement Actions: Marketing Rule Sweeps

- In 2024, the SEC charged 15 registered advisers with violations of the Marketing Rule
  - Alleged violations included disseminating advertisements that included untrue or unsubstantiated statements of material fact or testimonials, endorsements, or third-party ratings that lacked required disclosures and including advertising hypothetical performance on the adviser's website without having policies and procedures in place reasonably designed to ensure that hypothetical performance was relevant to the likely financial situation and investment objectives of each member of the advertisement's intended audience
- The SEC also charged one private fund adviser for violating the Marketing Rule for advertising returns experienced by a single investor without disclosing that the returns did not constitute overall fund performance but rather a representative investor's account
- Individual penalties ranged from $20,000 to $430,000

Selected Enforcement Actions: Sweep of Late Beneficial Ownership and Insider Transaction reports

On September 25, 2024, the SEC announced settled charges against 23 entities and individuals for failures to timely report information about their holdings and transactions in public company stock.

- Sweep focused on Schedules 13D and 13G reports and Forms 3, 4, and 5
- Penalties paid by firms ranged from $40,000 to $750,000, with penalties paid by individuals ranging from $10,000 to $200,000

A week earlier, SEC settled charges against 11 institutional investment managers for failing to file reports on Forms 13F

- Two of these managers were also charged with failure to file Form 13H
- Settlements resulted in over $3.4 million in combined civil penalties, ranging from $175,000 to $725,000
    - Two firms were not ordered to pay any civil penalties because they self-reported the violations at issue and otherwise cooperated with the SEC's investigations

Selected Enforcement Actions: Whistleblower Protection Rules

Rule 21F-17(a) under the Securities Exchange Act of 1934, prohibits taking any action to impede an individual from communicating directly with the SEC staff about possible securities law violations.

- *In the Matter of J.P. Morgan Securities LLC (January 16, 2024)*
  - Retail clients asked to sign confidential release agreements if they had been issued a credit or settlement from the firm of more than $1,000.
  - These agreements prevented clients from voluntarily communicating with the SEC.
  - JPMS agreed to pay $18 million civil penalty.
- *In the Matter of Nationwide Planning Associates, Inc. et al (Sept. 4, 2024)*
  - Retail clients asked to sign confidentiality agreements in connection with payments made to the clients' investment accounts to compensate for losses caused by alleged breaches of federal or state securities laws.
  - Agreements permitted communications only where the SEC first initiated an inquiry.
  - Combined penalties of $240,000
- *In the Matter of GQG Partners (LLC) (September 26,2024)*
  - Entered into NDAs with candidates for employment that prohibited disclosing confidential information about GQG, including to government agencies.
  - GQG paid $500,000 civil penalty

Selected Enforcement Actions: Custody Rule

- *In the Matter of Nebari Partners, LLC (September 17, 2024)*
  - RIA manager served as adviser to 3 private funds focused on the natural resources sector and 14 SPV pooled investment vehicles.
  - Custody audits were performed on the 3 funds but not the 14 SPVs.
  - Nebari agreed to pay a civil penalty of $80,000
- *In the Matter of Galois Capital Management LLC (September 3, 2024)*
  - Approximately half of the fund's assets were lost in 2022 with the collapse of FTX
  - SEC found Galois Capital failed to ensure that certain crypto assets held by the private fund that it advised were maintained with a qualified custodian.
  - Also found that Galois Capital misled certain investors by representing to them that redemptions required at least five business days' notice before month end while allowing other investors to redeem with fewer days' notice.
  - Galois settled and agreed to pay a civil penalty of $225,000
- *In the Matter of Cedar Legacy LLC (August 34, 2024)*
  - RIA manager adviser to three funds failed to timely distribute audited financial statements in investors and failed to promptly update its Form ADV after receiving audit opinions.
  - Cedar Legacy agreed to pay a civil penalty of $75,000

Selected Enforcement Actions: Hedge Clauses

- *In the Matter of ClearPath Capital Partners, LLC (September 3, 2024)*
  - Adviser with large separately managed account business also advised two private funds that relied on Investment Company Act section 3(c)(1).
  - Fund LPAs included a "hedge clause" which is language purporting to limit an adviser's liability in an advisory agreement. The agreement also had a "savings" clause.
  - Whether a particular hedge clause is misleading is a facts-and circumstances determination.

  "Except for gross negligence or willful malfeasance, or violation of applicable law, neither CCP, nor any of it's [sic] respective directors, employees, shareholders, officers or affiliates shall be liable hereunder for any action performed or omitted to be performed or for any errors of judgment in managing the Account. **Federal Securities Laws** and certain state securities laws impose liabilities under certain circumstances on persons who act on good faith, and therefore nothing herein shall in any way constitute a waiver or limitation of any rights which Client may have under any federal or state securities laws (or ERISA, if Client has a qualified plan there under)." (emphasis in original)

  - The SEC took the position that this language, which purported to waive the adviser's non-waivable fiduciary duty and stated that it was not liable for "any loss or damage" unless the result of "fraud, gross negligence, willful misconduct," when read in its entirety, was inconsistent with the adviser's fiduciary duty because it could mislead a client or investor into not exercising non-waivable legal rights.
  - As a result, the SEC stated that adviser violated Section 206(2) of the Advisers Act.

Selected Enforcement Actions: Conflicts of Interest

- *In the Matter of Closed Loop Partners, LLC (September 20, 2024)*
  - RIA failed to disclose certain conflicts of interest to its private fund clients, and to obtain prior consent, in violation of Section 206(2) of the Advisers Act.
  - The Manager caused certain funds to obtain loans that created conflicts of interests for the adviser.
  - For example, one fund client obtain a loan from lender without disclosing that advisory affiliate sat on the board of lender's 50% owner
  - In two other situations, the adviser made short term interest free loans to two fund clients. Because the adviser controlled the parties on both sides of the loans, the transactions were subject to inherent conflicts of interest that the adviser was obligated to disclose.
  - The failure to fully disclose and obtain consent caused the adviser to breach its fiduciary duties to the funds.
- *In the Matter of Macellum Advisors, LP (September 26, 2024)*
  - Adviser that deployed an activist strategy did not adequately disclose payments made to an affiliate from third party investment advisers that invested alongside the adviser's funds.
  - The agreements with third parties and related compensation posed conflicts of interest in that the adviser had an incentive to potentially favor the third party's interests – and the adviser's own interests – over those of its fund clients.
  - The adviser's generalized disclosures, that it "may" or "could" engage in outside activities and other conflicted transactions, was not sufficient given the repeated transactions.

Selected Enforcement Actions: Advisory Committees/LPACs

- *In the Matter of Colony Capital Investment Advisors, Inc. (September 3, 2024)*
  - Respondent routinely entered into agreements with advised private funds for services such as fund-level administrative services (such as tax, accounting, and legal support), as well as asset-level services (such as loan servicing, property maintenance, and property-level account).
  - Fund agreements required that transactions with affiliates be fully disclosed in advance to the funds' investors, approved by the funds' advisory committees or a majority-in-interest of its investors, as applicable, and respondent generally failed to do so.
  - In a settled proceeding, Respondent agreed that it violated 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder and agreed to pay a $350,000 penalty.
- *In the Matter of LDP Partners LLC and Himalaya Rao-Potlapally (October 7, 2024)*
  - Unregistered investment adviser to venture capital fund sought and received approval from the fund's advisory committee to take an advance of advisory fees earned monthly. These transactions were improper as the fund agreements did not allow the manager to take advance management fees, and the advisory committee was not authorized to allow the advancement.
  - Adviser penalized $10,000 and ordered to cease and desist from such future violations.
- *Takeaway: Highlights SEC's focus on adherence to fund agreements, particularly in relation to advisory committees.*

Selected Enforcement Actions: Exempt Reporting Adviser

- *In the Matter of ACP Venture Capital Management Fund LLC (September 20, 2024)*
  - Adviser claimed Private Fund Adviser Exemption when it did not quality for the exemption because there was operational and ownership overlap between the adviser and an affiliated entity that was a registered investment adviser. Because it did not qualify for the Private Fund Adviser Exemption or any other exemption, it was required to be registered.
  - Adviser and SEC registered affiliate had:
    - Overlapping owners and executives
    - The same CCO at each firm
    - Overlapping personnel including investment personnel
    - Operational overlap including operating out of the same office with no physical separation, shared the same email addresses, phone numbers and IT system.
    - No policies and procedures adopted to maintain separation.
  - Because the adviser was required to be registered, it failed to comply with the Custody Rule.

Selected Enforcement Actions: Use of Unregistered Broker

- *In the Matter of Ralph M. Trigg (September 16, 2024)*
  - Trigg acted as an unregistered broker by soliciting investors for and selling investments certain private funds including through in-person meetings, email and phone communications. He also provided offering and marketing materials to potential investors by phone and email.
  - Trigg also facilitated the purchase of fund interests by ensuring that certain investors executed subscription documents.
  - He received transaction-based compensation for each purchase of securities by investors he solicited.
  - In a settled action, Trigg agreed that he willfully violated Section 15(a) of the Exchange Act, which prohibits any broker or dealer from making use of the mails or any means or instrumentality of interstate commerce, to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security unless the broker or dealer is registered.
  - Agreed to a bar from association with, among others, any broker dealer or investment adviser, acting as finder, consultant or agent, and agree to a discouragement of all payments received, plus prejudgment interest and a $75,000 penalty.

Impact of AI on the Asset Management Industry

Speakers

- Matthew Crowley, General Manager – Ontra
- Lauren Zachry, Senior Counsel – Hellman & Friedman
- Sasha Burstein, Partner – K&L Gates

Developments in Private Funds

Speakers

- Anna Langs, Managing Director – SFERS
- Sasha Burstein, Partner – K&L Gates
- Andrew Feucht, Partner – K&L Gates
- Mark Heine, Partner – K&L Gates
- Margaret Niles, Partner – K&L Gates

Contents

01. Private Fund Adviser Rule Aftermath

PFA Aftermath

- Proposed rule vacated in its entirety
- No appeal to ruling made
- It is no longer a going concern and there is no expectation that it will be revived any time soon.
- What organizations and investors are doing post PFA.
    - ILPA is implementing a full revamp of the quarterly reporting template.
        - Effort to provide granularity in reporting similar to what was proposed in the PFA

PFA Aftermath (cont.)

- What organizations and investors are doing post PFA.
  - ILPA is implementing a full revamp of the quarterly reporting template.
    - Effort to provide granularity in reporting similar to what was proposed in the PFA
  - Investors assessing portions of PFA that were of highest priority for them and seeking these through negotiations.
    - Back to status quo
    - Focus on negotiating information and reporting
    - Adviser examination fees, defence costs, and penalties
    - GP-led secondary disclosures

02. Liquidity Trends

Liquidity Trends

In response to a lack of traditional liquidity options in the current market we have seen an expansion in possible ways to provide liquidity in private funds.

We include below certain noteworthy liquidity options we are seeing more of in the current market:

- LPA Language Permitting Alternative Options
- GP-led secondaries
- Fund to Fund transfers (same manager)
- Fund-Level Borrowing

Each of these options will be discussed in more detail.

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Liquidity Trends (cont.)

LPA Language Permitting Alternative Liquidity Options.

- It is now quite common for new funds to include language permitted various alternative liquidity options.
  - Authorizing language is drafted broadly to give GP maximum flexibility to pursue all available alternative liquidity options available.
    - Other "alternative transaction structures" that achieves liquidity
  - The most common approach we are seeing are single asset or multi asset transfers of assets to continuation funds
  - In certain cases the GP seeks broad rights to amend the agreements to effect liquidity options
  - Some require approval of the LPAC to move forward with liquidity option
- Intended to address current situations where GPs are looking to pursue alternative liquidity options but existing LPAs do not provide authority.

GP-Led Secondaries. GP-led secondaries are transactions where the GP organizes a separate vehicle (a "Continuation Vehicle") to which a Fund investment will be transferred. It is typical for third party money to be invested in the Continuation Vehicle, with the GP offering the Limited Partners of the Fund the option to receive a "cash-out" or "roll-over" the investment.

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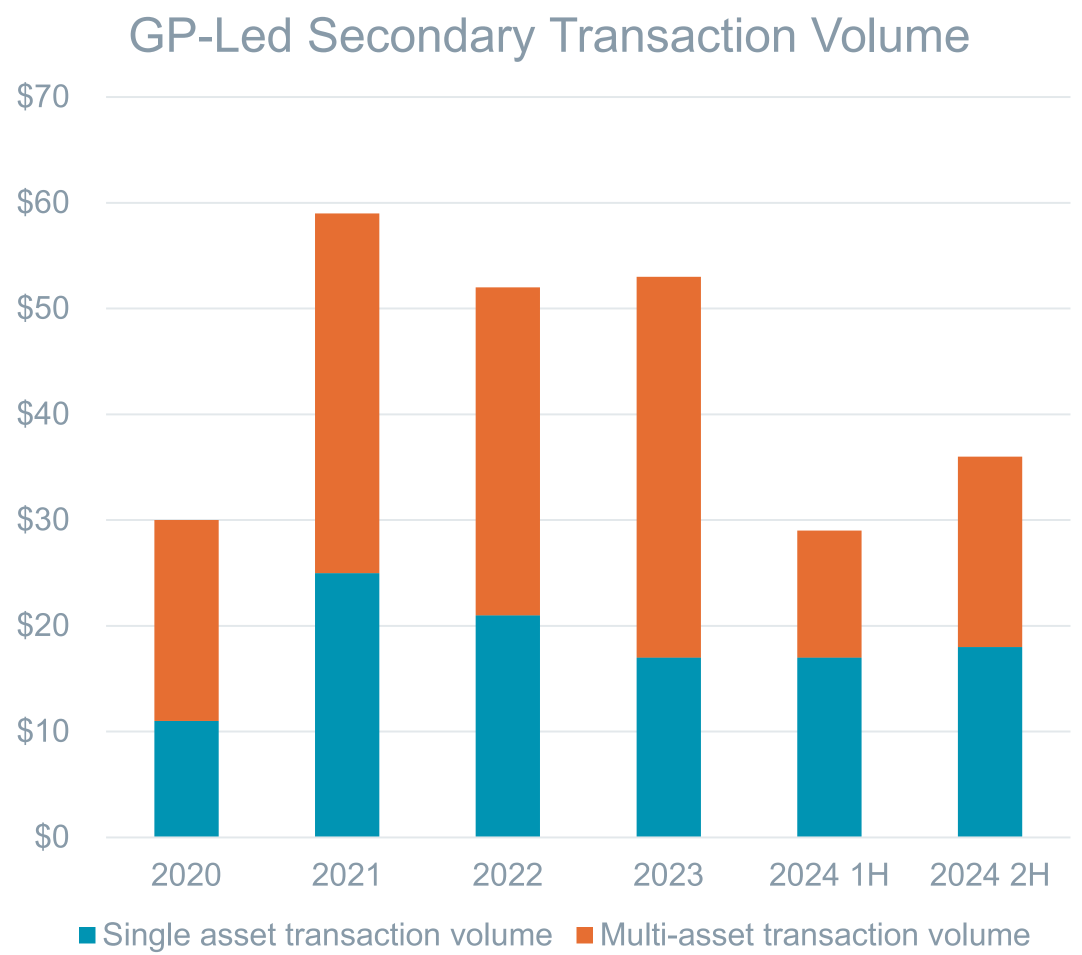
Liquidity Trends

PE firms provided a range of reasons for focusing on GP-led secondaries

71% of firms said they see these structures as a means to pursue more lucrative opportunities.

65% of firms focused on the flexibility of portfolio company holding periods the strategies can provide.

Only 35% of firms pointed to a lack of exit opportunities as a reason to focus on GP-led secondaries.



Liquidity Trends (cont.)

Fund to Fund Transfers (Same Manager). Fund to fund transfers involve situations where a predecessor fund transfers an interest in a portfolio company to the current fund that actively investing.

Fund-Level Borrowing. We have recently seen language being inserted that expressly permits the GP of a fund to engage in borrowing for the specific purpose of making distributions to the investors (presumably in advance of an upcoming liquidation event).

03. Carried Interest/Incentive Fees

Carried Interest/Incentive Fees

- With respect to closed-end private funds, we have seen a number of variations on the typical carried interest mechanics. As a general matter, there has always been tension between fund managers and their investors regarding the timing and calculations of carried interest.
- From the manager's perspective, there is pressure to obtain and pay carried interest to team members so soon as possible, as this is a primary driver to attract and retain top talent in the industry. From the investor's perspective, the expectation that capital be returned prior to carried interest being paid is both reasonable and valid.
- As noted, we have seen some recent variations to the typical models, in some cases to address the issues references above and in other cases to provide the manager with a level of compensation that it deems appropriate. The following pages include a summary of a few of these recent developments.

Carried Interest/Incentive Fees (cont.)

- **Tiered Carried Interest.** Tiered carried interest structures provide for the GP's carried interest percentage to increase upon satisfying certain return thresholds. These types of structures have been used in venture funds for a few years, but we are starting to see these mechanics in other private funds as well (e.g., growth; small PE).

  Key issues to consider include (i) threshold return calculations; and (ii) GP "catch-up" terms.

- **Hedge-Fund Type Mechanics (Credit Funds)**. We have seen recent closed-end credit funds incorporate "annual carried interest allocations" based on net appreciation in the portfolio (both realized and unrealized gains). In addition, net gains/losses for each year are allocated among the partners based on their opening capital account balances for the applicable year – this provides the GP with a "compounding" effect with respect to its allocations of carried interest.

Carried Interest/Incentive Fees (cont.)

- **Hybrid European/American Waterfalls.** These "hybrid" mechanics provide for investment proceeds split in half and then distributed to the Partners in accordance with separate distribution waterfalls, one a European-style (or return of all capital first) waterfall and the other an American-style (or deal-by-deal waterfall).
- **End of Commitment Period Special Distribution**. Although rare, we have also seen fund agreements that include a "special distribution" at the end of the Fund's commitment period, which provides for the GP to receive a full distribution of the amount of carried interest it would receive if the Fund were liquidated based on the Fund's current fair market value (including unrealized gains in the portfolio).
- **Carried Interest Calculations Including Unrealized Gains**. In some closed-end funds, we see carried interest distributions based on both realized and unrealized gains, with the GP having broad discretion to designate the portion of investment proceeds that represent a return of invested capital and what portion represents investment profits.

04. Major Institutional Investors Adopting OCIOs

OCIO

- Recent announcements of OCIO engagements
  - UPS
  - Nokia
  - Others
- Shift away from self-managed private asset portfolio management
- Outsourcing seen as cost savings
- Changes market dynamics for invested dollars
  - Direct investors have focus on broad range of factors
  - OCIOs tend to focus on fees to exclusion of other factors.

05. Fund Structuring

Fund Structuring

As a general matter, we have seen some recent “trends” with respect to Fund structuring.

- **Cayman Islands to Delaware**. We have seen a recent trend where venture funds are shifting from the Cayman Islands to Delaware. While this has been most notable in the venture space, we have seen this change with other private funds as well.

- The fundamental drivers here include the following:

  - AML Requirements. The AML requirements in the Cayman Islands are comprehensive and this can be especially burdensome for “smaller” funds from a compliance cost perspective.

  - Operating Costs. Like everything else in the world, the costs of operating a Fund in the Cayman Islands has increased. This includes the use of Cayman Islands counsel on most fund-related legal matters, which would be in addition to U.S.-based legal counsel. While not a huge factor, we have heard from managers that the costs of operating a Cayman Islands based fund have been a factor.

  - Non-U.S. Investors. One historical factor for managers to organize in the Cayman Islands is that it can be more attractive to non-U.S. investors that simply want to avoid any connection with the United States tax authorities. Over time, it is our experience that this has become less and less of a factor for non-U.S. investors.

Fund Structuring (cont.)

- **Regulatory Structuring.** While regulatory structuring considerations are certainly not new, we have seen a growth among larger funds to create “parallel” vehicles, with one vehicle dedicated to European-based investors and the other dedicated to U.S.-based investors, with the primary reasoning being that the European-targeted funds will include all AFIMD compliance requirements.
- **Aggregation of Management Side-by-Side Vehicles.** Some fund managers have historically created parallel (or side-by-side) vehicles for the specific purpose of facilitating participation in Fund investments by the management team, friends/family and strategic investors. A recent trend we have seen is the “collapsing” of these vehicles into the main Fund. In doing so, the Fund LPA will typically include language providing for separate “classes” or “sub-partnerships,” with the intention that each separate “class” be treated for all practical purposes as a stand-alone vehicle. Some key thoughts/considerations are as follows:
  - <u>Underlying Rationale.</u> Cost savings (i.e., audit; general operating costs).
  - <u>Key Legal Points.</u> If/when drafting or reviewing this type of structure, some of the key points to consider include the following: voting mechanics; investment allocation across the sub-partnerships; sharing of expenses; sharing of investment proceeds, among others.

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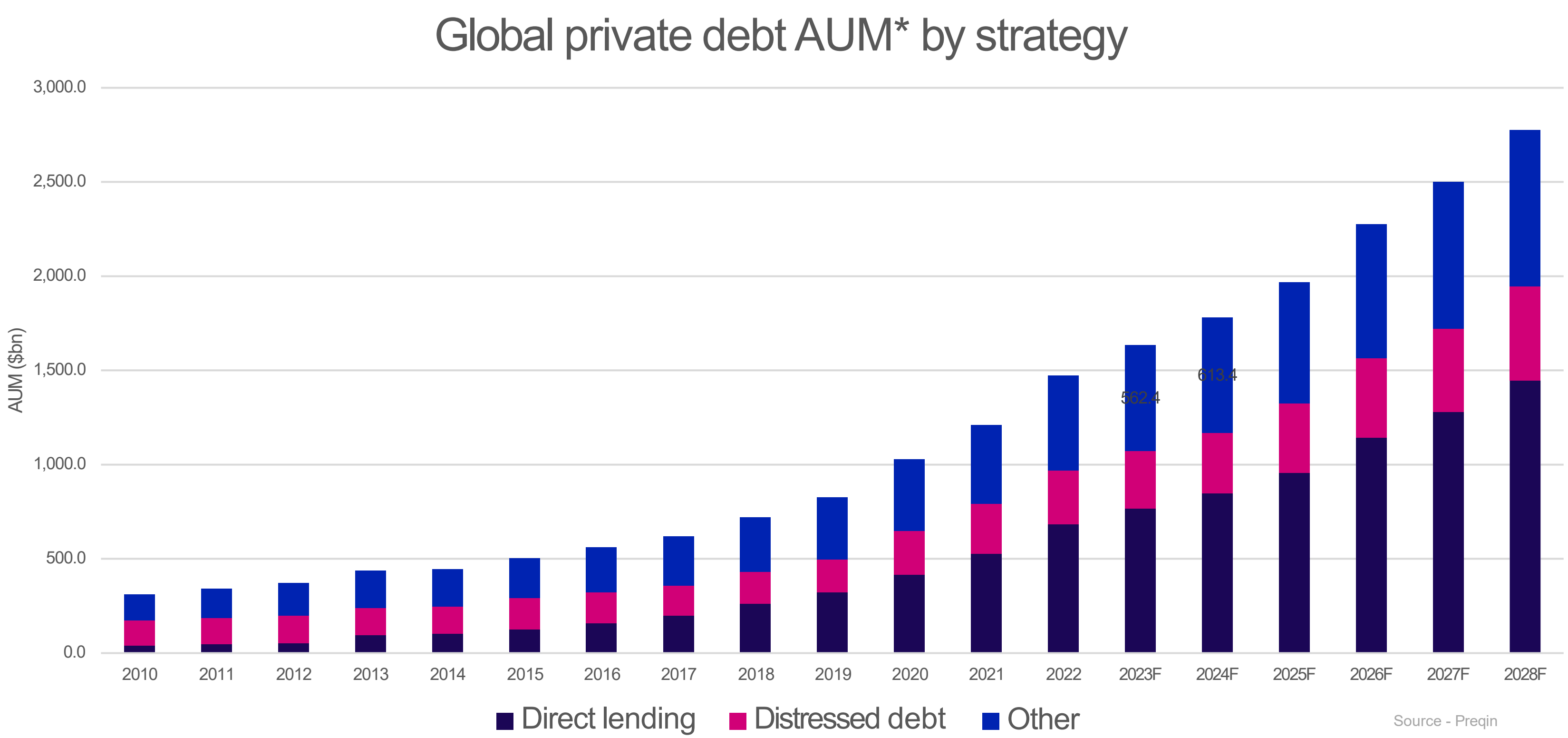
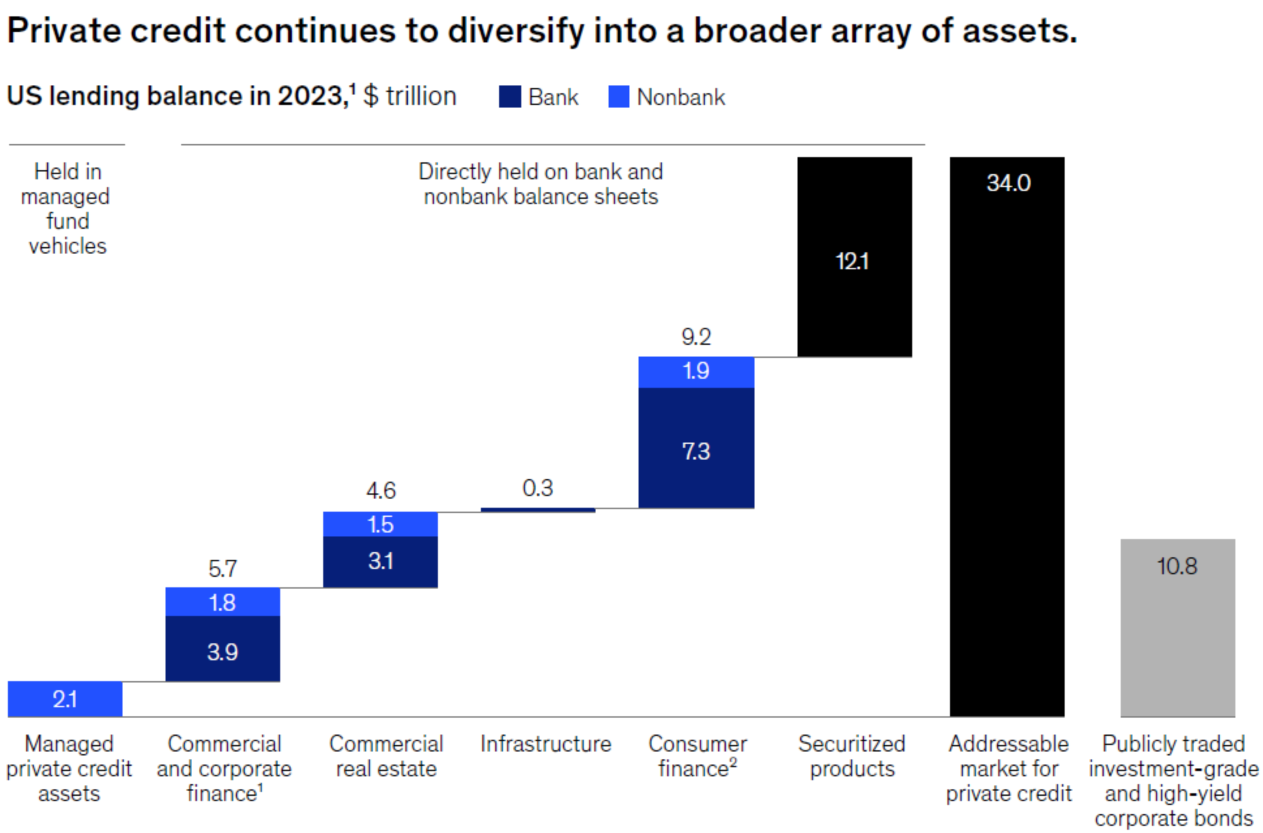
Private Credit – A Compelling Strategy

- Private credit has over the past several years been one of the most attractive asset strategies for institutional investors.
- Many private credit strategies involve the origination of loans by U.S.-based fund sponsors.
- At the same time, private credit attracts strong interest from foreign investors that require solutions to U.S. tax challenges.
- Deploying foreign capital in private credit on a tax-efficient basis requires thoughtful structuring solutions and careful planning.
- There is a continuous and growing interest in demand for evergreen fund structures from institutional investors and the private wealth channel

Private Credit (cont.)



Private Credit (cont.)



[1]Includes aircraft and railcar leasing, equipment leasing, receivables financing, standard corporate loans, and trade finance.
[2]Includes auto loans, credit card receivables, residential mortgages, student loans, and unsecured personal loans.
Source: Preqin; Securities Industry and Financial Markets Association; Global Banking Pools by McKinsey; McKinsey analysis

McKinsey & Company

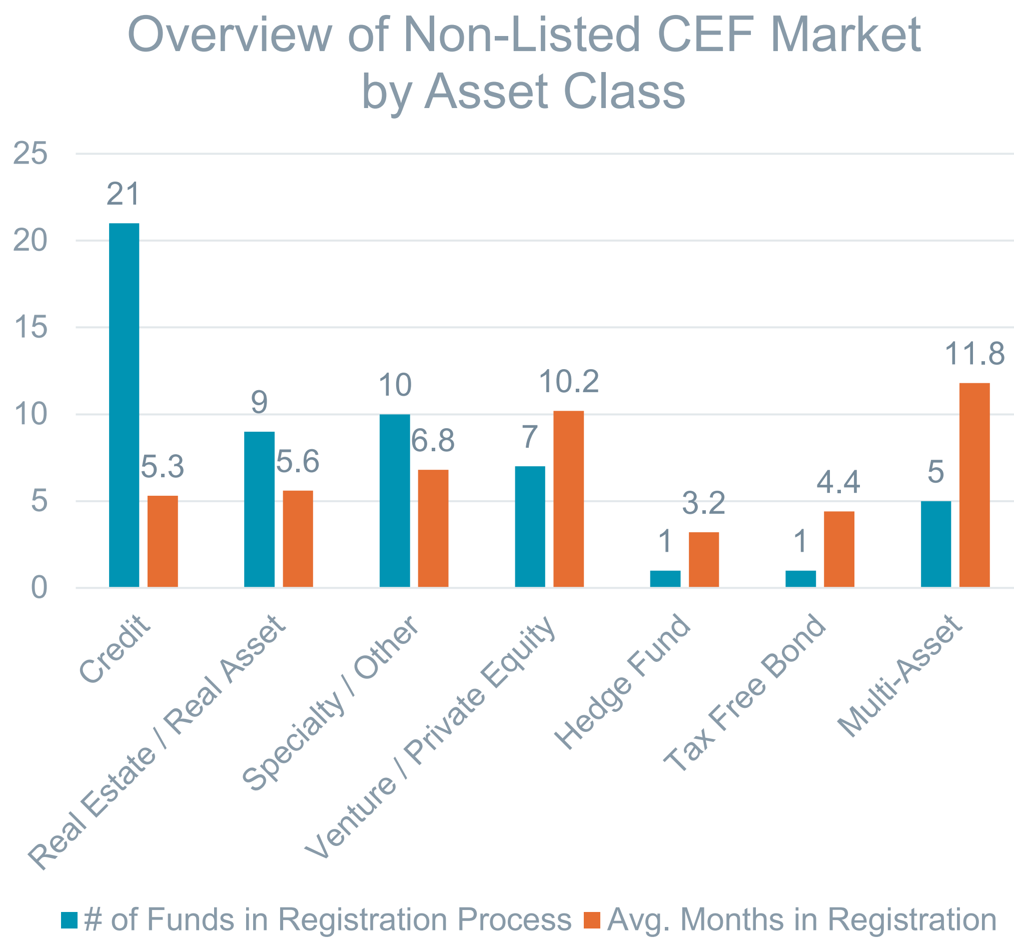
Fund Structuring – Spotlight on Alternative Investment for the Wealth Channel

- Many advisers recommend alternative assets, strategies and/or structures as part of an investor's diversified investment portfolio
- Closed-end funds are the only practical vehicle for allowing non-ultra high net worth investors to access most alternative assets
- **Interval funds** and **tender offer funds** provide access to alternative strategies and less liquid investments, with potentially higher yields, without the requirement for daily redemptions like mutual funds
- However, they also implement the regulatory safeguards of a registered fund
- Combine attractive features of closed-end funds and open-end funds
- Are not subject to ERISA and may take any amount of tax deferred investors
- Block UBTI and ECI once qualified as a regulated investment company (RIC) for pass-through taxation and 1099 reporting to investors

Market Overview

As of October 31, 2024, there are 242 non-listed CEFs managing $192 billion in assets:

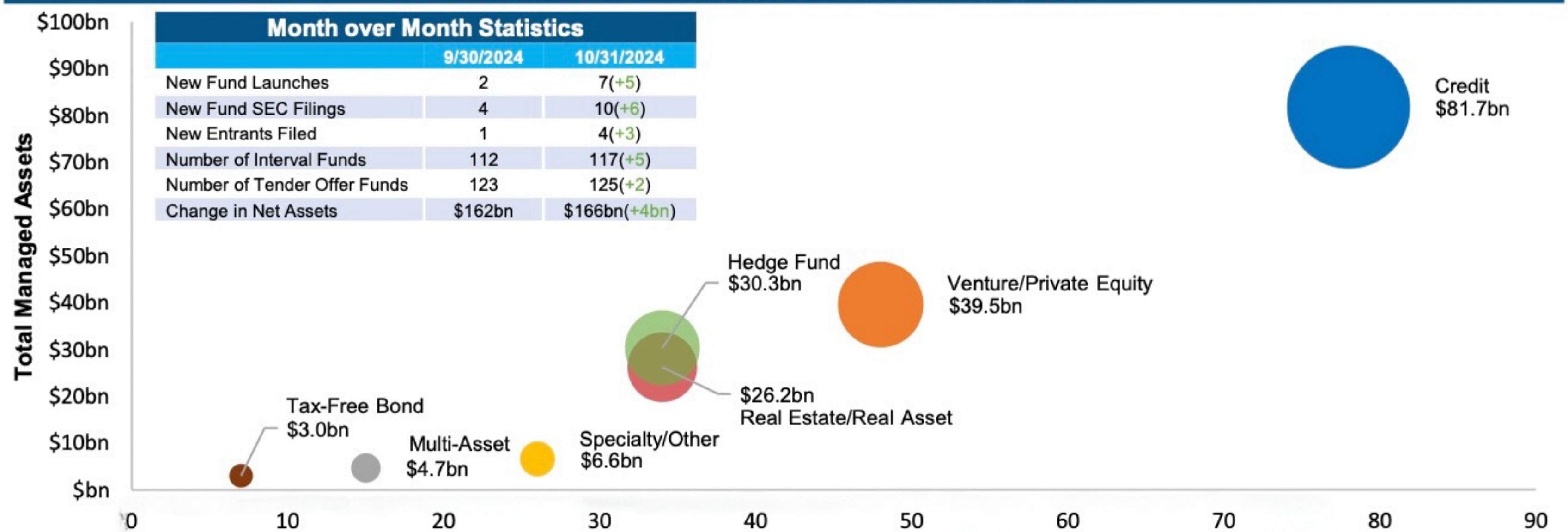
- 125 **tender offer funds** manage $72.13 billion in assets
- 117 **interval funds** manage the remaining $113.16 billion



* Data as of October 31, 2024. Source: XA Investments, LLC

Market Overview (cont.)

Overview of Non-Listed CEF Market by Asset Class[1]



Month over Month Statistics

	9/30/2024	10/31/2024
New Fund Launches	2	7(+5)
New Fund SEC Filings	4	10(+6)
New Entrants Filed	1	4(+3)
Number of Interval Funds	112	117(+5)
Number of Tender Offer Funds	123	125(+2)
Change in Net Assets	$162bn	$166bn(+4bn)

[1] As of October 31, 2024 *Source: XA Investments, LLC

06. Other Noteworthy LPA Trends

Other Noteworthy LPA Trends

- Concentration of Law Firms Used by GPs. We have seen sponsor-side law firms becoming more concentrated.
- Most Favored Nation Provisions. MFN "carve-outs" continue to be expanded to the point of eviscerating the spirit of the provision, including the GP's right to exclude side letter provisions granted to certain "designated LPs."
- Negative Consent Provisions. While these provisions are not new, they have become much more commonplace in the industry.
- Alternative Liquidity Option Language.

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Post-Election Overview and Look Ahead to 2025

Speakers

- Daniel Crowley, Partner – K&L Gates
- Karishma Page, Partner – K&L Gates

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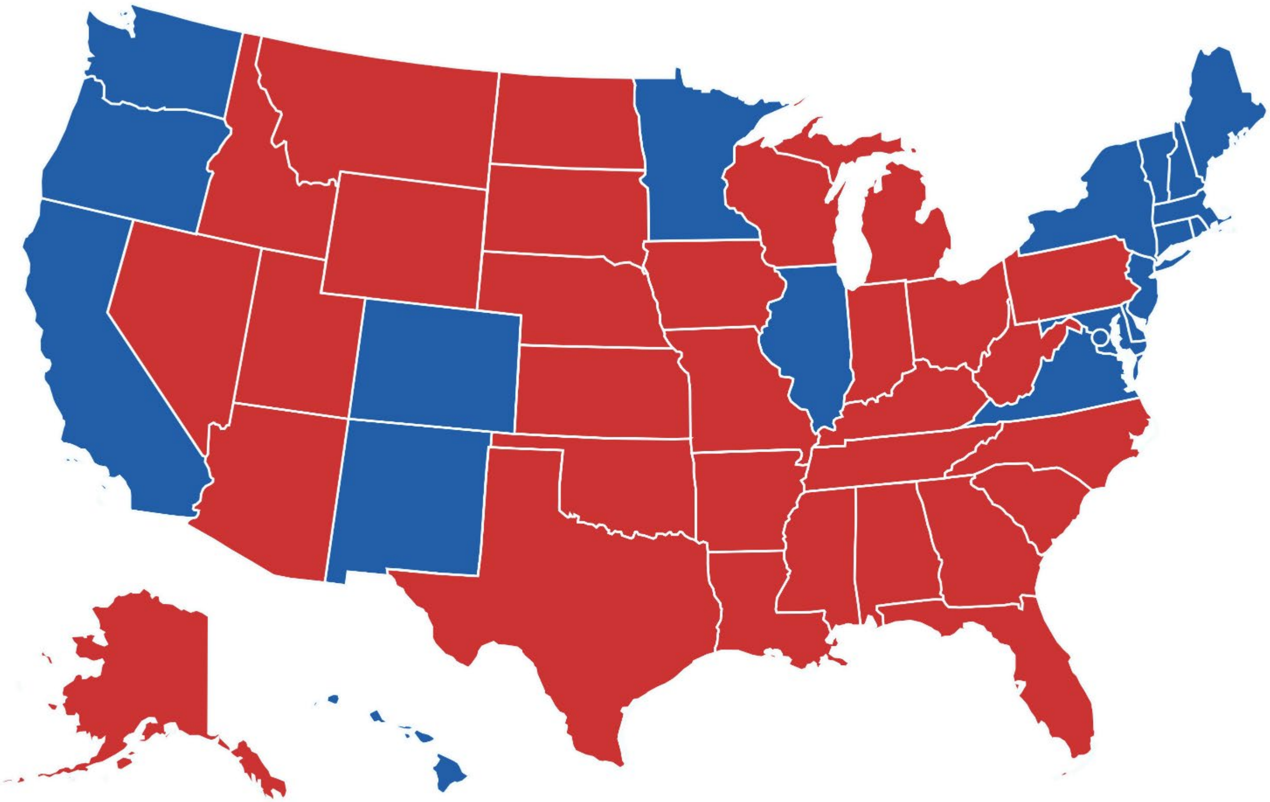
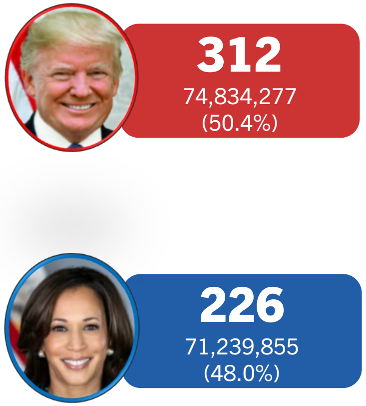
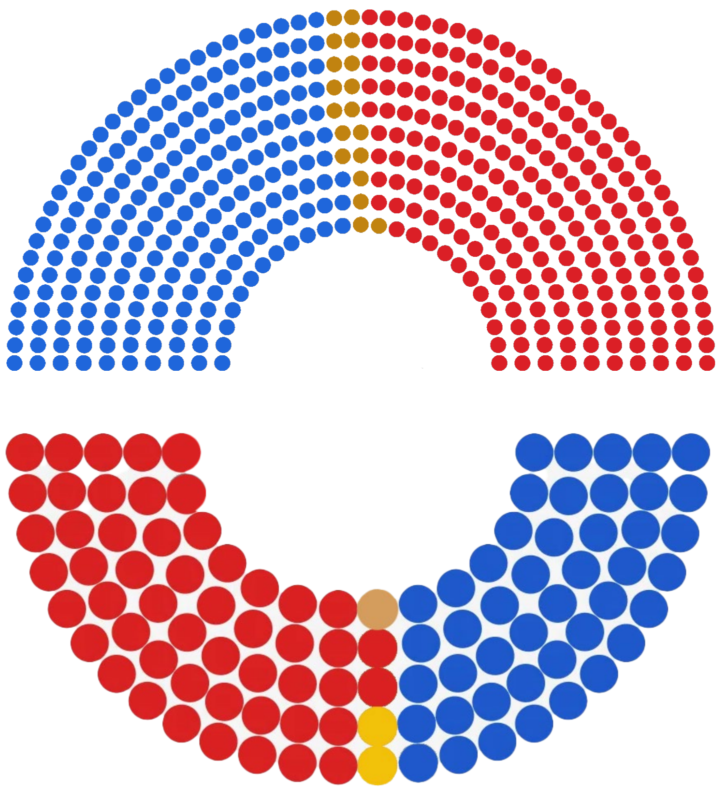
White House: President-elect Trump Wins Decisively





119th Congress



- Republican
- Democrat
- Independent
- Too close to call/Recount

Source: AP News

HOUSE OF REPRESENTATIVES

Republican: **218**
Democrat: **212**
Too Close To Call: **5**

SENATE

Republican: **53**
Democrat: **44**
Independent: **2***
Too Close To Call/Recount: **1**

**Caucus with Democrats*

The Red Wave

- President Trump and Congressional Republicans have a perceived **mandate**
  - Vote for candidates v. context
  - Election will have **consequential policy impacts**
- Immediate reversal of Biden-era policies (EOs/CRA), fast legislative push, executive/ regulatory/compliance action, oversight, powerful social/traditional media leverage, DOGE
- **But also, a moment in time:** political pendulum swing continues to accelerate; political physics could easily result in a flip in House control in 2026 midterms

The Trump Agenda

- Trump won on two primary issues:
  - **Inflation** – appointees will be committed to a pro-economic growth agenda, including “DRILL BABY DRILL” to lower energy costs
  - **Immigration** – focus is on securing the boarder and deportation of documented criminals.
- Trade negotiations will revolve around:
  - **Tariffs** - goal is to address trade imbalances
  - **Energy** - goal is U.S. industry dominance
  - **China** – goal is economic and military isolation

Legislation is Not the Only Tool in the Box

- **Congressional Review Act**
  - Expect the Biden Administration to finalize as many regulations as possible before Jan. 20
  - CRA can be used to rescind regulations finalized by a prior administration; majority votes
  - CRA window is roughly August 1, 2024 through end of March, 2025
  - THE CATCH: Cannot issue “substantially similar” regulations once rescinded. Substantially similar is not defined. Republicans will need to use this tool strategically so they are not throwing the baby out with the bathwater.
- **Executive Branch**
  - Trump Administration can reopen regulatory projects
  - Can issue sub-regulatory guidance
  - Can pause open regulatory and guidance projects
  - Can issue executive orders
  - Agency appointees
    - Policy priorities, resource allocation
- **The Courts**
  - Challenges to regulations pursuant to *Loper Bright* and *Chevron* deference
  - Challenges pursuant to *Corner Post*
  - Courts may be how the SEC Climate Risk Disclosure rules get vacated

What's Next

- Lame Duck Session Priorities
  - Must pass legislation
    - FY2025 federal funding
      - Timing unclear
    - FY2025 NDAA
    - Farm Bill
    - Debt ceiling
  - Senate judicial nominations
  - Leadership elections and conference rules

Committee Leadership Changes - HFSC

Patrick McHenry (R-NC), **Financial Services**

- GOP contenders (clockwise from top left): Andy Barr (R-KY), French Hill (R-AR), Frank Lucas (R-OK), and Bill Huizenga (R-MI)




Maxine Waters (D-CA), **Ranking Member, Financial Services**

- Key Priorities:
  - Racial equity and D&I-related efforts
  - Oversight of big banks and "bad actors"
  - Consumer protection
  - Housing affordability and access
  - Digital assets

Committee Leadership Changes - Banking

Tim Scott (R-SC), **Chair, Banking, Housing & Urban Affairs**

- Also likely NRSC Chair
- Key Priorities:
  - Capital formation
  - Reducing regulatory burdens
  - Housing
  - Digital assets

Sherrod Brown (D-OH), **Banking, Housing, & Urban Affairs**

- Defeated in reelection race
- Next most senior member without an existing role as top Democrat on another committee is Sen. Elizabeth Warren (D-MA)

Looking Ahead: Financial Services Policy

- Changes in committee leadership may have changes in policy priorities
- Republicans have signaled that a key aspect of their political platform is to undo certain “woke” financial policies implemented by the Biden administration and Democrats, as well as the Basel III Endgame proposal
- Top oversight priorities will likely include:
  - ESG-related regulations, including countering the “Green New Scam,” proxy voting issues, corporate governance, etc.
  - D&I-related regulations and agency initiatives, including human capital disclosures
  - International regulatory frameworks affecting U.S. companies (e.g., EU Corporate Sustainability Due Diligence Directive)
  - Regulations from the CFPB, SEC, and other financial regulators

However, Slim Margins Remain

- Despite Republicans having control of the White House and Congress, slim majority margins will continue to play a role in lawmaking and will necessitate bipartisanship
- Some areas of potential bipartisan agreement will likely include:
    - China investments
    - Digital assets
    - Regulation of AI in financial services
    - Need for substituted compliance with EU regulatory regime

Impact on ESG Policy

- Congress and Trump administration will work together to undo Biden-era regulations on climate, "equity," etc.
  - CRA resolutions, EOs, and rulemaking
  - Primary GOP targets will likely be asset managers and proxy advisories
- EU Sustainability Reporting Regimes
  - Will push back on extraterritorial impact of CSRD and CSDDD on US companies
- State Laws
  - Will seek to preempt state laws (e.g., CA climate laws) if not vacated in court

Trump Administration – Potential Regulatory Impacts

- SEC
  - Trump has promised to remove current Chair Gensler "on day one." It is unclear at this point who will be Chairman
  - Focus on rolling back Biden administration regs, particularly related to:
    - Climate risk disclosure
    - Proxy advisors
    - Shareholder proposals
    - Digital assets
- CFPB
  - Unclear at this point who will be Director. Trump plans to remove current Director Chopra expeditiously
  - Focus on reducing regulatory framework

Tax Reform and Related Priorities

- 2025 Tax Reform
  - 2017 Tax Cuts and Jobs Act temporary provisions expire
  - Trump Administration/GOP Congress want to incentivize US manufacturing, bolster US supply chains and competitiveness
  - Big tax bills are few and far between – pent-up Member appetite to consider their pet policies
  - Interest in rolling back Biden-era policies, like clean energy
- Budget Reconciliation
  - Requires only 51 votes in the Senate, not the usual 60 (GOP expected to hold 53 seats in the Senate)
  - Budget reconciliation is an arcane process that limits what can be included in the package
  - **Even with only a majority vote requirement, intra-party disagreements, especially over the deficit, could snag the process**

When Do We Expect Tax Legislation?

- Republicans are formulating their tax packages **now**
- We may see report-outs from the HWMC Tax Teams on public comments very soon
- Republicans will kick-off the budget resolution/budget reconciliation process in January
- We may see legislative proposals even before a budget resolution containing budget reconciliation instructions is passed – a marker for policies
- GOP hopes to move legislation within first 100 days
  - That may be optimistic, depending on tensions between policies and offsets, tolerance for adding to the deficit
- Despite optimistic projections, this could drag out