Private Markets Quarterly Update

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New Marketing Rule Performance Net Return Calculation Methodologies

By Tanner Beverly

As we approach the November 2022 deadline for implementation of the U.S. Securities and Exchange Commission's (SEC's) new **Marketing Rule**, many private fund advisers are concerned about the general prohibition of gross-only performance. The Marketing Rule prohibits any presentation of gross performance without the inclusion of net performance with at least equal prominence, calculated for the same time period, and using the same type of return and methodology as the gross performance.[1] It is important to note that gross performance is defined as the "... performance results of a portfolio or portions of the portfolio that are included in extracted performance, if applicable, before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's advisory services to the relevant portfolio."

This is a general requirement and applies to all performance, including extracted and hypothetical performance. For many private fund advisers, this will require the analysis of all performance currently shown on a gross-of-fees basis to understand the implications of this change and determine the appropriate response. Per the Adopting Release text, where advisers show gross extracted and hypothetical performance, they will be required to calculate and present a corresponding net return.

Extracted Performance

Extracted Performance in the new Marketing Rule is defined as "the performance results of a subset of investments extracted from a portfolio."[2] Common types of extracted performance include deal-level, sector, geographic, and realized and unrealized aggregations. Where extracted performance is shown, performance of the entire portfolio must be provided or offered to be provided promptly.

There has been (and will likely continue to be for the foreseeable future) increasing debate around whether deal-level (singular) performance is considered extracted performance under the new Marketing Rule. One notable argument, eloquently dubbed the S-theory, suggests that performance of a singular investment from within a portfolio would not be considered extracted performance under the new rule as the rule refers to a subset of investments (plural), which, by definition, must include more than one investment.

The S-theory has been met with opposition by those who read the Adopting Release's statement that "... net performance applies not only to an entire portfolio but also to a portion of a portfolio that is included in extracted performance."[3] The term "portion of a portfolio" seems to encompass all deals, singular and plural. Further, in the context of discussing case studies and the Marketing Rule's restrictions on referencing specific investment advice, the Adopting Release also states that "... case studies that include performance information also will be subject to the final rule's restrictions and requirements for performance advertising."[4] Only time will tell how the SEC staff will view single deal-level performance. Whatever stance an adviser makes based on their own assessment of the risks, the rationale for the decision should be documented, and any related policies, procedures, and disclosures are clear and robust.

1 **Rule 206(4)-(1)(d)(1)**
2 **Rule 206(4)-(1)(e)(6)**
3 **Adopting Release pg. 171**
4 **Adopting Release pg. 81**

Hypothetical Performance

Common types of hypothetical performance include target returns for new funds, projected returns (e.g., projected exit returns for unrealized investments), and any composite (aggregation) of the performance of a select group of deals extracted from multiple portfolios (e.g., a fund manager presenting the aggregate performance of all energy sector portfolio investments made by Funds I-IV in the context of marketing a private fund focused on energy investments).

The Marketing Rule conditions the presentation of hypothetical performance on the adviser adopting certain policies and procedures and requires that advisers provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance.[5] Where hypothetical performance is permissibly advertised under the Marketing Rule, net performance should reflect the fees and expenses that "would have" been paid if the hypothetical performance had been achieved by an actual portfolio.[6] The definition of net performance refers to the deduction of all fees that an investor "has paid or would have paid" in connection with the services provided.

When advertising hypothetical performance, the new Marketing Rule requires a private fund manager to provide – or if the intended audience is a private fund investor, to provide, or offer to provide promptly – sufficient information to enable the intended audience to understand the risks and limitations of using the hypothetical performance in making investment decisions.[7]

Calculation Methodologies for Extracted and Hypothetical Performance

Under the final rule, presentation of "net performance" in advertisements may reflect the deduction of a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted. Private fund managers may consider calculating net returns for extracted and hypothetical performance using either an actual fee or model fee calculation methodology.

Allocating actual fees and expenses applied on a pro-rata basis to specific deals with relevant carried interest calculations may be difficult for many advisers. Books and records requirements for calculation support may also be difficult to maintain depending on the length of any track record. Where records are sufficient, when calculating an IRR, advisers should reflect the fees as dollar amounts within the IRR stream of cash flows. As the IRR is not additive, reducing gross returns by geometric or arithmetic means is mathematically incorrect.

When applying model fees (which, historically, has been the common approach the industry has taken for hypothetical performance), an adviser generally should apply a model fee that reflects either the highest fee that was charged historically or the highest potential fee that it will charge the investors or clients receiving the particular advertisement.[9]

For composites of extracts that may be relevant to a new fund, advisers should assess the impact of fees and expenses intended to be charged by the relevant fund. For example, if management fees are charged on committed capital and carried interest earned on a hurdle rate, then the model fee should apply the highest relevant fee rates. When expenses are not captured in the gross performance results, firms may identify an appropriate model rate to reduce the gross hypothetical track record.

Target and projected returns should also be reduced by the highest anticipated model fees and expenses that are likely to be incurred with respect to any portfolio or to the investment advisory services with regard to securities offered in the advertisement.

Conclusion

The SEC's new Marketing Rule introduces some new concepts that have not applied to private fund managers under current regimes. It's important for advisers to consider the type of performance shown and implement practices that are achievable for the firm to maintain consistently. Please refer to ACA's **white paper**, which includes a guide on how to present performance in line with the new rule, as well as our **Marketing Rule resource page**.

5 **Rule 206(4)-1(d)(6)(ii)**
6 **Rule 206(4)-1(e)(10)**
7 **Rule 206(4)-1(d)(6)(iii)**
8 **Rule 206(4)-1(e)(10)(ii)(A)**
9 **Adopting Release pg. 179**

The SEC's New Marketing Rule – Challenges for Real Estate Advisers

By Erika Chua

Advisers that focus on real estate strategies are working through some unique issues as they prepare to implement the provisions of the new **Marketing Rule** by November 4, 2022.

Net Performance Requirement

One of the largest challenges faced by real estate advisers is how to address the requirement to provide net performance information wherever gross performance is presented. In particular, advisers are trying to determine whether and how asset-level performance and attribution metrics can be shown net of fees when they have historically been presented gross of fees. Use of a model fee and expense methodology that is applied on a pro-rata basis may offer one solution but can be difficult to implement in practice.

Marketing of Joint Ventures and Separate Accounts

The new Marketing Rule requires advisers to show 1-, 5-, and 10-year performance for any portfolios or composites that are not "private funds." The rule defines private funds as an issuer that would be an investment company under the Investment Company Act of 1940 if not for an exemption under section 3(c)(1) or 3(c)(7) of the Act. For those real estate managers who want to advertise the performance of joint ventures or separate accounts, which are typically not structured as private funds, they must determine how these types of entities should be presented in light of the new Marketing Rule.

Marketing of 3(c)(5) and Other Pooled Vehicles

Advisers to 3(c)(5) funds and other types of pooled vehicles are wondering how such vehicles fit into the guidance of the new Marketing Rule if they are not technically considered private funds. While 3(c)(5) funds are not explicitly addressed in the new rule, some managers are following the rule's guidance on marketing of private funds as a practical approach, particularly since such vehicles often rely on multiple exemptions that may also include 3(c)(1) or 3(c)(7).

Marketing of Third-Party Ratings

The new Marketing Rule addresses the presentation of third-party ratings, which are defined by the rule as "rating or ranking of an investment adviser provided by a person who is not a related person … and such person provides such ratings or rankings in the ordinary course of its business." Any use of third-party ratings in advertisements is subject to several considerations, including whether the questionnaire or survey used in preparing the rating makes it equally easy to provide favorable and unfavorable responses and the inclusion of certain disclosures, such as whether the adviser paid a fee to participate in the rating or ranking.

Many real estate managers include information in marketing materials about their Global Real Estate Sustainability Benchmark (GRESB) scores, which capture information about environmental, social, and governance (ESG) performance and sustainability best practices of real estate entities. The new Marketing Rule's guidance on what constitutes a "third-party rating" leaves some questions about whether GRESB scores or other ESG-type metrics, such as LEED certifications for specific buildings, would be in scope under the new Marketing Rule. Advisers are considering whether they should disclose more information about the ratings to ensure such claims could not be seen as misleading.

Our Guidance

Given the uncertainty around the impact that certain provisions in the new Marketing Rule will have on the practices of real estate managers, we recommend that advisers work closely with outside counsel or compliance consultants to understand the options and risks that apply to different approaches.

Proposed Amendments To Form PF (Round 2) – What Private Markets Fund Managers Should be Aware Of

By Vivek Pingili

On August 10, 2022, the SEC and Commodity Futures Trading Commission (CFTC) jointly adopted **proposed amendments** to Form PF that would significantly expand reporting by private fund advisers. The SEC proposed an earlier round of amendments to Form PF earlier this year, which we analyzed in our **Q1 2022 update**. While many aspects of this second round of proposed amendments are aimed at the hedge fund industry, certain elements of the proposal are relevant to all private fund advisers subject to Form PF reporting obligations. Certain aspects of the proposal can potentially significantly increase the operational compliance burden for private markets fund managers.

Separate Reporting - Master-Feeder and Parallel Fund Structures

The proposal seeks to amend how advisers report master-feeder and parallel fund structures. Form PF currently allows a private fund adviser to choose whether it wants to report master-feeder and parallel fund structures in the aggregate or separately so long as it does so consistently throughout Form PF. The proposal seeks to generally remove this flexibility and require advisers to separately report each component fund of a master-feeder arrangement and parallel fund structure. The SEC's stated rationale for requiring such more granular reporting is that it will allow easier comparison across filers and complex fund structures, thereby increasing the usefulness of data collected on Form PF.

Investments in Other Funds

The proposal seeks to amend Instruction 7 to Form PF to require an adviser to include the value of a reporting fund's investments in other private funds when responding to questions on Form PF, unless otherwise directed by the instructions to a specific question. In justifying this approach, the SEC states that the current flexibility on whether to disregard underlying funds when responding to questions has undermined the utility of the data collected, as it provides unclear, inconsistent data on the scale of reporting funds' exposures. Additionally, the proposal seeks to amend Instruction 7 to prohibit advisers from looking through a reporting fund's investments in internal private funds or external private funds (other than a trading vehicle, as described below), unless a question specifically directs the adviser to report exposure obtained indirectly through positions in such funds.

Trading Vehicles

Perhaps one of the most controversial and burdensome aspects of the proposal involves a new requirement that "trading vehicles" be, under certain circumstances, treated as a separate reporting fund and not be aggregated with the reporting private funds to which they are related. The proposal defines a trading vehicle as a wholly owned separate legal entity that holds assets, incurs leverage, or conducts trading or other activities as part of the private fund's investment activities, but which the adviser does not operate as a business. At first glance it may seem that this type of entity doesn't hold relevance to private markets fund managers. However, the SEC proposal seems to signal that this would pick up special purpose vehicles (SPVs), holding vehicles and other similar entities commonly found in private markets fund structures by clarifying that trading vehicles can encompass entities in a private fund structure created for "jurisdictional, tax or other regulatory purposes."

In structures where a trading vehicle is wholly owned by a single reporting fund, advisers will continue to have the option of consolidating information about the trading vehicle in the related reporting fund's responses. However, where a trading vehicle is owned by multiple reporting funds (which is often the case in more complex private markets fund structures), it must be separately reported. Given it is common for private markets fund structures to use separate SPVs for individual portfolio company investments, the separate reporting requirement could significantly increase the reporting burden for advisers. While the application of the proposal here is less clear in the case of alternative investment vehicles (AIVs) organized to accommodate the tax and/or other needs of reporting funds investors in relation to specific investments made by a reporting fund, it would seem logical that where an AIV is related solely to a single reporting fund, the current approach of consolidating its reporting with that of the related reporting fund would continue to remain acceptable, whereas an AIV would need to be separately reported where it has been organized to accommodate investors from multiple reporting funds (e.g., parallel funds).

The SEC's rationale for separate reporting, such as providing more granular insight into risks arising at the trading vehicle-level (e.g., position size- and counterparty exposure-related risks), does not seem to be especially relevant in the private markets context where such vehicles are used largely (if not exclusively) for tax-efficiency and/or regulatory reasons and do not typically involve risks different from those at the top-tier reporting fund-level. Additionally, where co-investors invest directly into a SPV, it is already common practice to treat that SPV as a co-investment fund and report it as a separate reporting fund.

Reporting Unfunded Commitments

The proposal would require private fund managers to separately report the value of unfunded commitments (that have historically been included in the gross and net asset values reported on Form PF and the gross asset values reported on Form ADV). The SEC has justified its rationale for this more granular reporting by stating the following in the release to the proposal: "…there are circumstances where understanding the amount represented by unfunded commitments would enhance our understanding of changes to a reporting fund's net and gross asset value over time, inform us of trends, and improve data comparability over the life of the fund. For example, knowing the value of uncalled commitments would help the [SEC, CFTC] and FSOC more accurately identify how much leverage a fund with uncalled commitments has. Currently, the [SEC, CFTC] and FSOC only can infer this information but it is unclear whether such inferences are correct."

Inflows and Outflows

The proposal would require private fund managers to report information relating to a reporting fund's inflows (which are unlikely to be applicable to closed-end fund managers) as well outflows. In relation to reporting on outflows, while redemptions and withdrawals are likely to be less frequent in the closed-end fund context, distributions that a private fund made to investors during the annual reporting period will now have to be reported. This could significantly add to the reporting burden, especially for private markets fund managers with numerous funds and several distribution events across their funds over the course of a reporting year. The SEC's rationale for this additional type of reporting is that it will permit the SEC to more accurately gauge how much the private fund industry has grown from cash flows versus performance.

Other Expanded Reporting Obligations

The proposal seeks to enhance reporting relating to various other items (the vast majority of which will be inapplicable to private markets fund managers). These, in relevant part, include revisions to the fair value hierarchy for assets and liabilities, additional categories of beneficial ownership reporting and permitting private markets fund managers to show a fund's performance as an internal rate of return since inception (in lieu of the periodic rates of return currently required in tabular format, that may be more suitable for hedge funds and liquidity funds). The proposal seeks to define "internal rate of return" as "The discount rate that causes the net present value of all cash flows throughout the life of the fund to be equal to zero." Finally, the proposal would require internal rates of return for periods longer than one year to be annualized, whereas internal rates of return for periods less than one year must not be annualized.

Task Force on Climate-Related Financial Disclosures Quick Reference Guide

ACA's ESG Advisory team has seen increasing support for the Task Force for Climate Related Disclosures (TCFD) across its client base. The framework helps managers globally address and disclose climate-related risks and opportunities, and many of the objectives therein align with the Principles for Responsible Investment (PRI). In the UK, asset managers above £5bn or over 500 employees are required to comply with TCFD. ACA's ESG Advisory team put together a comprehensive guide on TCFD principles and best practices, **available here**.

ACA Group Acquires Data Specialist Ethos ESG to Offer First Data Analytics Product

ACA Group recently acquired Ethos ESG, a provider of environmental, social, and governance (ESG) ratings data and software for financial advisors, asset managers, institutions, and investors.

This acquisition marks ACA's first analytics offering, which will be paired with ACA's ESG experts to form an integrated tech and advisory offering under the ESG Advisory practice. ACA's existing ESG Advisory practice supports with a range of programmatic needs for firms that integrate ESG into their business or investment activities. This currently includes advice and implementation support around strategy, policies/procedures, regulations and frameworks, training, and external reporting, among other areas. With Ethos, ACA's clients will now also be able to easily analyze investments and automate several elements of ESG reporting. Read more about this acquisition **here**.

SEC's Continued Focus on Valuations - Risk Management & Investment Processes

By Vivek Pingili

In our private markets updates in 2020, we analyzed the pointed questions we started to see the SEC ask back then related to the impact of COVID-19 on private markets fund advisers and their respective funds and portfolio companies, including questions related to valuations, the corresponding documentation maintained by advisers (including valuation back-up data) and valuation reporting to limited partners. While the negative impact of COVID-19 has significantly diminished since 2020 for the vast majority of private market fund advisers (and their respective portfolio companies), we are continuing to see the SEC maintain its focus on risk areas such as valuations, portfolio company risk management/oversight and investment processes that were especially critically at the height of the COVID-19 crisis.

Valuation Processes

The SEC exam staff are consistently focusing a fair bit on Level 3 asset valuations and the policies and procedures implemented by private markets firms to ensure not only accurate valuations but also: (i) timely and clear receipt of financial and other pertinent information from portfolio companies and (ii) timely and comprehensive communications to investors around material portfolio company valuation-related developments. Perennial focus areas include lack of adequately granular policies and procedures, lack of sufficient documentation to evidence compliance with policies and procedures and failure to adequately document grey area decisions made (especially when implicating potential conflicts). For example, we have seen the SEC scrutinize the failure to document why it was deemed appropriate to seemingly abruptly cease using public company comparable input data in valuing an investment in a portfolio company (where such data had historically played an important role in valuing this investment) at a time when the public company stock prices experienced a significant decline.

» **Look-Back Testing** - Since the onset of COVID-19, we have seen a renewed push from the SEC to have private markets firms perform look-back testing on their valuations upon exiting investments. This push commenced before COVID-19 (driven in part by often overly-rosy valuations of unrealized investments being marketed in an aggressive fund-raising environment that often proved unjustified at the time of exit). Since the onset of COVID-19, there has been a significant increase in the number of instances where portfolio company exit values that have fallen short of the pre-exit valuations that were marketed to prospects and/or reported to existing limited partners (LPs).

A look-back test upon exiting an investment can improve upon their current valuation process for similarly situated investments in the portfolio and ensure such investments are fairly and accurately valued. In a look-back testing exercise, the SEC expects private markets firms to, enhance their existing valuation processes for the type of investments where the interim valuations were materially more optimistic than realized valuations - by taking into account lessons learned from valuation methodologies and assumptions being utilized by prospective buyers (and/or their valuation agents) independently valuing such investments.

Risk Management

ACA recommends that private markets firms engage in frequent check-ins with their portfolio companies and carefully monitor and assist their fund portfolio companies in tackling material challenges at these companies that could potentially impair the value of a fund's investment in such companies. For example, in the private credit context, based on our SEC examination experience, monitoring for loan covenant defaults and breaches by portfolio company borrowers that are material and communicating such matters to investors has become a must. Further, where there have been multiple defaults and/or covenant breaches that may have been immaterial in any one instance, fund managers should evaluate whether these are material in the aggregate.

During the height of the COVID-19 crisis, many portfolio companies were woefully unprepared for COVID-related disruption and needed significant and pro-active assistance from the sponsors of their private equity fund owners (e.g., help securing an alternative supplier, help with a SBA loan application, or legal advice on complicated and novel issues that may be outside the expertise of their regional/local counsel). Many private markets firms were caught off guard by these portfolio company developments and had to add internal and external resources to effectively and swiftly combat these challenges. The importance of assessing (and reporting to investors on) portfolio companies' state of preparedness in tackling evolving or new risks that could cause significant disruption in the private markets in the future has not waned, and we continue to see the SEC probing in this area to ensure private markets firms have not become complacent.

As with valuation-related developments, it is imperative that private markets firms continue to report other types of material developments at, and challenges experienced by their fund portfolio companies in a consistent manner and in real time (as opposed to waiting to do so until the next reporting period). SEC examiners continue to focus on whether private market fund advisers are promptly reporting material developments to their investors.

GP Fund Buybacks and Restructurings

Several private markets funds raised during the dizzying heights of inflows the private fund industry experienced in the years leading to the 2008/09 global financial crisis have approached the end of their terms over the last few years (many having gone through multiple term extensions). In an effort to provide liquidity to investors anxious to exit these funds that have been operating for over a decade, and based on the conviction that holding on to residual assets in these funds for a longer period may result in better exit results, many fund general partners (GPs) have offered in recent years (and continue to offer) to buy-back LP interests to facilitate LP exits and fund liquidations.

The SEC has always viewed GP buy-back transactions as fraught with conflicts of interest and carefully scrutinized such transactions to ensure GPs have comprehensively disclosed all material data and considerations relating to such transactions (and, in particular, whether the valuations of the underlying residual assets have been undertaken in a fair manner – especially when the services of independent third-party valuation service providers were not used).

For example, in 2018, the SEC took enforcement action against a private equity fund's GP for failing to disclose to selling LPs (or adjusting its original offer in light of) a potentially significant increase in the valuation of a fund's residual assets had occurred between the time when the private equity firm made its buy-out offer and the time by which the overwhelming majority of the LPs had accepted the GP's offer. In the current climate where uncertainties relating to valuation matters have only intensified, it is not surprising that the SEC has stepped up its scrutiny of GP buy-backs.

GPs considering engaging in buy-backs or other types of fund restructuring transactions should err on the side of caution and consult with legal counsel to thoughtfully disclose developments relating to underlying investments the GPs anticipate acquiring from their LPs in such transactions. Such GPs should also consider utilizing the services of an independent valuation provider (with relevant experience) to value such investments (or at least take into account and disclose to selling LPs the valuation analysis and opinions of such a service provider in connection with offer negotiation processes). Certainly, the involvement of such an independent service provider in the valuation processes at the core of such buy-back transactions can minimize the appearance of conflicts inherent to such types of transactions. The SEC and many LPs believe such independent valuation opinions are important and the SEC's proposed rules from earlier this year aimed at the private fund industry specifically require this for GP-led restructurings.

Investment Due Diligence & Portfolio Management Processes

While SEC examiners started to push private markets firms to formalize their investment due diligence (initial and ongoing) and portfolio management processes, this push has become more prevalent since COVID. There is little doubt that risks from inadequate due diligence and oversight of portfolio companies are real. For example, a firm that acquired a portfolio company based on strong investment fundamentals and the promise of growth and increased revenues at the portfolio company, but without conducting thorough due diligence on the quality of such company's financial accounting and reporting processes, likely has had to expend a fair bit of time, energy, and expense post-due diligence to enhance these processes. Through this clean-up exercise, such a firm may have realized that the fundamentals of the acquired company may not be as strong as initially surmised, which could force the firm to significantly revise its risk/return expectations for the investment.

Currently, we are seeing the SEC explore whether firms are being consistent in their due diligence processes from deal to deal on common denominator risks (e.g., cybersecurity, background checks on senior management of portfolio companies, pending litigation (if any), and quality of financial accounting and reporting processes at portfolio companies). The SEC is also looking to ensure that firms' policies cover the entire spectrum of the various elements in the lifecycle of an investment from how deals are sourced and due-diligenced through: (i) the various formalities that need to be completed between initial due diligence and completion of deals (including initial and final approvals; additional due diligence; submission of indications of interest, letters of intent and term sheets, and investment memos); (ii) the ongoing due diligence and portfolio company oversight processes (including portfolio company reporting processes) and (iii) ultimately culminating in the processes around exiting portfolio companies.

SEC Enforcement Action Highlights the Risks of Business Communications Through Unapproved Mobile Apps

By Vivek Pingili

In a **recent article**, we discussed the increasing importance for private fund managers (and other types of investment advisers) to more effectively track, archive, and surveil their employees' business-related communications across all mobile apps being utilized. In the article, we included several practical tips about how private fund managers can manage business and reputational risks in this fast-evolving area of SEC scrutiny. Around the time we published the article, the SEC took one of its first (if not the first) enforcement actions against a private fund manager and its founder for various alleged failures in this area, as discussed below in greater detail. This enforcement action, which involved the SEC stipulating a comprehensive corrective-action plan, highlights why managing risk in this area through comprehensive and cutting-edge regulatory technology (RegTech) software tools, like **ACA's e-comms surveillance software**, is no longer an optional best practice.

SEC Allegations

The SEC alleged that even though the private fund manager's compliance manual restricted business communications to firm-provided email accounts and certain messaging platforms (like Microsoft Teams and Bloomberg Chat), multiple personnel of the private fund manager (including its founder) communicated via various mobile apps on personal devices (such as iMessage and WhatsApp) that were neither authorized not archived. These communications included recommendations and advice made or proposed for clients, the movement of client funds, and securities sale and purchase orders.

The SEC further alleged that the restrictions in its compliance manual relating to permissible business communication channels (and related record-keeping requirements under the Investment Advisers Act) were not enforced. Additionally, the SEC alleged that by not updating its compliance manual to permit and archive business communications through the above-mentioned additional channels, the fund manager violated the Adviser's Act's requirement to adopt and implement an adequately tailored compliance program. Further, apart from not producing any text messages in response to a SEC staff's investigative subpoena, before the fund manager was made aware of the SEC investigation, the founder, on multiple occasions, allegedly instructed at least one officer of the fund manager to delete all text messages.

SEC-Stipulated Corrective Action Plan

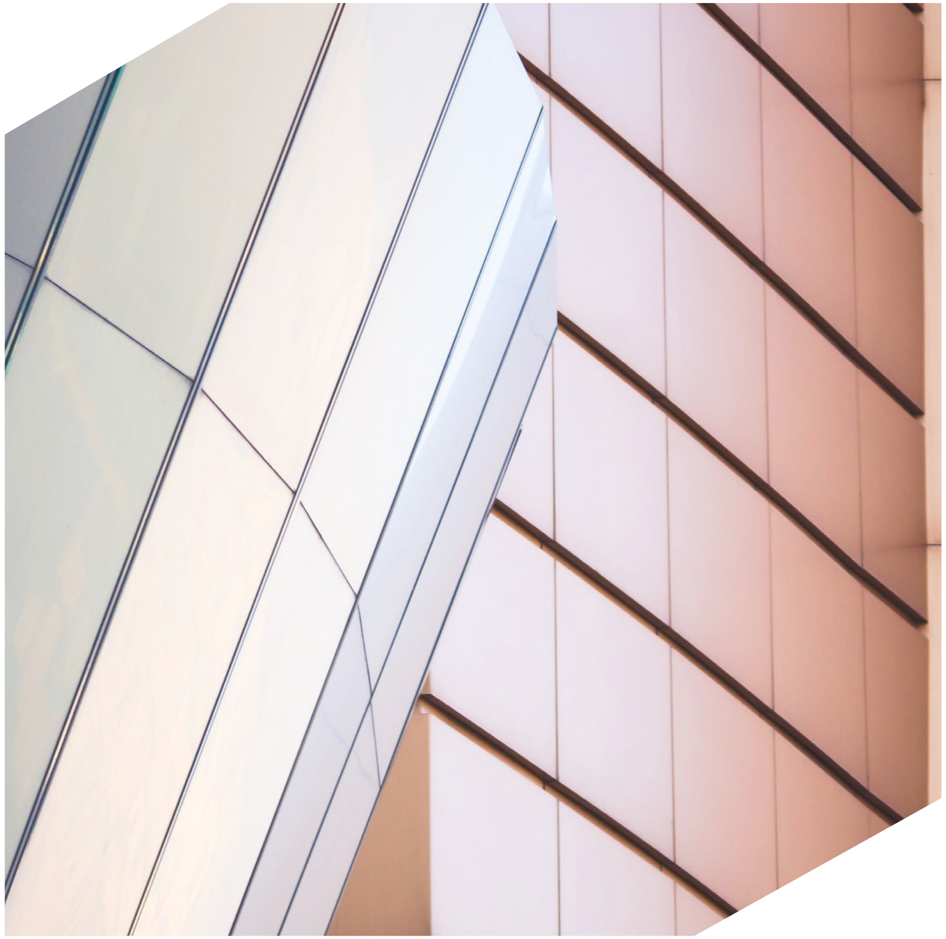
Perhaps even more noteworthy than the SEC's allegations is the corrective action plan that the fund manager and its founder had to agree to. This corrective action plan (described below) along with the practical takeaways in our recent blog should provide private fund managers solid actionable takeaways to better manage risks in this area.

Under the SEC mandated corrective action plan, the private fund manager is required to retain an independent compliance consulting firm to assist it with the following tasks:

» A review of the private fund manager's surveillance, compliance, and archiving policies and procedures (and training provided to employees) designed to ensure that its electronic communications, including those conducted via mobile apps on personal devices, are conducted in accordance with applicable regulatory requirements. A review of employee certifications of compliance with the foregoing policies and procedures to ensure these are being submitted quarterly.

» An assessment of the technological solutions that the private fund manager has begun implementing to assist with the above tasks, including an assessment of the likelihood that employees will use such technological solutions going forward and a review of the measures employed by the private fund manager to track employee usage of new technological solutions.

- A review of the private fund manager's electronic communications reviews to ensure they are covering business communications sent via mobile apps.
- An assessment of the steps taken by the private fund manager to prevent the use of unauthorized communications channels for business communications.
- A review of the framework adopted by the private fund manager to address instances of non-compliance by employees with the foregoing policies and procedures. This review should include corrective action taken in instances of non-compliance, an evaluation of who violated policies and why, what penalties (if any) were imposed, and whether penalties were handed out consistently across business lines and seniority levels.



Other Notable Recent Enforcement Actions

By Neha Pasricha & Vivek Pingili

Over the past quarter, the SEC has brought multiple enforcement actions against exempt reporting advisers (ERAs) and other types of unregistered private markets fund managers. As noted in our spotlight on ERAs earlier in this Update, these enforcement action trends are fairly emblematic of the SEC's continued desire to protect investors investing with unregistered private markets fund managers (irrespective of the size and scale of their investment operations) and hold such managers responsible for violations of fiduciary duty obligations that are very similar (if not identical) to those the SEC expects of SEC-registered fund managers (RIAs). Below, we summarize a few recent representative examples of this enforcement activity, which we believe provide noteworthy lessons of broad relevance to the private markets fund industry.

Enforcement Action Emphasizing Contractual Compliance

In one enforcement action brought against a private markets ERA, the SEC charged the firm for allegedly incorrectly calculating post-investment period management fees for multiple venture capital funds as noted below.

- Alleged failure to appropriately reduce the invested capital base for management fee step down calculations during a fund's post investment period where such a reduction is required under the fund's governing documents (in instances where investments in portfolio companies have been written down).
- Alleged incorrect inclusion of accrued-but-unpaid interest attributable to certain portfolio company investments in the fee base for post investment period management fee calculations, which was allegedly not permitted under the applicable fund governing documents.
- Alleged failure to timely implement the post-investment period management fee step-down upon the end of a Fund's investment period, which resulted in management fees being calculated based on total commitments for a portion of the post-investment period.

Takeaway: Over the years, the SEC has brought an increasing number of enforcement actions of this type against ERAs and RIAs. Additionally, the SEC's **private fund risk alert** from January 2022, which we summarized in our **Q1 2022 private markets update**, has an entire section dedicated to contractual compliance failures uncovered in SEC examinations (including failure to calculate management fee step-downs in accordance with fund governing documents).

This scrutiny demonstrates the SEC's increased willingness to dig deep in terms of reviewing and testing compliance with complex private markets fund governing documents that investors have expended significant energy and costs to negotiate. Leveraging legal documents management software tools, such as **ACA's ComplianceAlpha® platform**, to effectively monitor and track compliance with complex economic and other terms in fund governing documents (including variations across funds) and side letters is becoming increasingly crucial, and no longer an optional best practice. To find out more about how software tools can be used to effectively manage contractual compliance obligations, please view this **webcast**.

Enforcement Actions About Misleading Marketing & Prohibited General Solicitation

- In a recent enforcement action, the SEC sanctioned an ERA and its principals for violation of Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder by allegedly making material misrepresentations in offering materials for the private funds they managed. The ERA's fund PPMs stated the funds' financial statements were audited annually and named certain audit firms as the funds' auditors. In reality, the principals hadn't made efforts to retain any audit firm, the funds' financial statements were never audited, and none of the named audit firms were ever engaged to audit the financial statements of the funds. The adviser continued to use the PPMs to solicit new investors or retain existing investors.

Takeaway: This action illustrates the SEC's focus around misleading statements in marketing materials (whether intentional or unintentional), which is another central theme in the January 2022 SEC private fund risk alert noted above. Over the past few years, we have seen a steady increase in SEC enforcement actions and examination deficiency findings around misleading marketing activities. With the compliance deadline for the SEC's new Marketing Rule fast approaching, we anticipate this trend will likely only increase.

In light of this, it is now more important than ever to carefully review marketing materials (including pitchbooks, PPMS, DDQs and RFP responses, as well as website and social media disclosures) both for consistency in disclosures as well as factual inaccuracies and other potentially misleading statements. In furtherance of these goals, fund managers should take steps to develop and periodically update standardized disclosure libraries that can be leveraged to ensure consistent and well-vetted disclosures across various marketing formats. Similarly, fund managers should maintain back-up data for all factual assertions referenced on their websites and/or social media platforms, as well as in marketing materials - including in any third-party content (such as a press release issued by a portfolio company) incorporated into marketing materials. The use of software tools to assist with these efforts is becoming increasingly vital, especially for fund managers that are creating a large repository of marketing materials for use in fundraising.

» In a recent enforcement action brought against an unregistered real estate firm, the SEC sanctioned the firm for various alleged fraudulent representations in the fundraising context, including touting the performance of multiple private equity real estate funds with external capital that apparently did not exist (and, instead, were transactions undertaken by the firm's principal where no third-party capital was invested. Perhaps the most noteworthy aspect of this enforcement action is the SEC's allegations that the firm engaged in prohibited general solicitation via Twitter, YouTube, and other social media platforms (with the goal of driving traffic to the firm's website) by offering to sell interests in private real estate funds to prospective investors with whom the firm had no pre-existing, substantive relationships. Several of the prospects that were targeted including unaccredited investors in multiple states.

Takeaway: This action illustrates the SEC's increasing focus on Regulation D compliance that we have seen over the past few years. Both in the examination and enforcement context, we are seeing the SEC analyze whether private fund managers conducting general solicitations via 506(c) offerings or the more traditional 506(b) offerings are getting the requirements for these offerings mixed up (even if unintentionally). For example, we have seen the SEC publicly and privately sanction firms intending to engage in 506(b) offerings for engaging in prohibited general solicitation by referencing funds on their websites or in press-releases relating to investment activity (even where there were no explicit references to any fundraising underway). We have also seen the SEC probe how firms established a pre-existing substantive relationship with prospective investors, indicating that maintaining documentation (in a log tracking engagement activity with prospects or in a CRM database) evidencing such efforts is becoming increasingly critical. Similarly, in instances where firms have attempted to conduct 506(c) offerings, we have seen the SEC scrutinize whether these firms (either on their own or by engaging third party service providers) ran independent accredited investor verifications on prospective investors (as opposed to simply relying on self-representations in subscription documents, which is acceptable only in the 506(b) offering context).

Regulatory Changes in the UK Could Present Promising Opportunities for Private Markets Emerging Managers

By Adam Palmer & Andrew Poole

The financial impact of recent lockdowns and subsequent economic upheaval has been well documented and current inflationary pressures and recessionary fears cast shadows across the wider financial world. As longer term investors will tell you, some of the greatest opportunities arise in times of uncertainty or market dislocation. For emerging managers this may prove to be that exact point in time.

Adam Palmer and Andrew Poole take a look at some of the current factors that may allow new managers to come to market and how they could take advantage of the prevailing sense of uncertainty **in this piece, which was originally published in Private Equity International**. (A subscription is needed to view this article.)

A Brief Primer on Co-investments

By Vivek Pingili

Private markets fund sponsors have offered opportunities to larger investors and other strategic parties to co-invest in a deal alongside a primary fund for years. However, there has been a significant increase in the popularity of co-investments, both amongst fund sponsors and investors, over the past decade.

A fund organized to pool co-investment capital can be deal-specific, with the investor deciding to commit co-invest capital to a particular deal that the investor is interested in. Alternatively, a fund sponsor may also set up a so-called "overage fund," typically as a blind-pool vehicle, that is designed to invest opportunistically whenever a sponsor's main fund has satisfied its investment appetite for certain deals. Further, a sponsor may choose to avoid the burdens of managing co-investment vehicles by offering prospective co-investors the ability to invest directly into the applicable portfolio company or other asset, though (as further described below) the resulting complications associated with such direct co-investments may outweigh the burdens noted above.

Historically, it was more common for fund sponsors to permit co-investors to invest directly at the asset-level, primarily to avoid the administrative burdens associated with managing these co-investments on behalf of investors. However, such direct investments can result in multiple challenges and complexities for all involved. For example, co-investors and senior management of portfolio companies who would have to negotiate investment and divestment terms directly with one another, which may not be ideal for co-investors (particularly less sophisticated ones) looking to more passively rely on their fund sponsors to negotiate on their behalf. For fund sponsors, such direct investments may require additional time and resources to ensure conflicts between their primary funds and these co-investors are adequately managed throughout the lifecycle of the co-investments. For example, fund sponsors would need to review the investment and divestment terms such co-investors' negotiate with portfolio company management to ensure the terms are not materially more favorable vis-à-vis sponsors' primary funds and, at a minimum, do not disadvantage these primary funds).

Today, driven in large part by the sheer scale of co-investments being undertaken, as well as the increasing SEC scrutiny of conflicts inherent in the co-investment process, the private markets industry has generally concluded that the aforementioned challenges outweigh the marginal costs for fund sponsors of setting up a pooled vehicle to manage co-investments. For fund sponsors, pooling co-investors into vehicles under their control gives sponsors the ability to efficiently and effectively manage (and disclose) the spectrum of conflicts inherent to the co-investment process (as described in greater detail).

Benefits

Co-investment opportunities have become increasingly popular amongst fund investors as they allow such investors to allocate more capital to a sponsor whose performance track record and other characteristic they like. Further, since most co-investment vehicles are offered on a no-fee, no-carry basis, this further incentivizes fund investors to participate in co-investment opportunities offered by their fund sponsors.

For prospective investors who have not invested with a fund sponsor before, co-investments are increasingly viewed as free test rides whereby new investors evaluate the sponsor's investment acumen via smaller co-investments before allocating a larger amount of capital via such sponsor's next primary fund.

For both existing and new investors, co-investments can be an efficient way of increasing their exposure to a desirable sector or even a particular asset (e.g., one they may already have exposure to via a primary fund and whose growth trajectory they like). For example, if an investor is particularly impressed by a sponsor's renewable energies team, the investor might try to co-invest solely in renewable energy-related co-investment opportunities that are presented to it, as opposed to such sponsor's blind pool vehicles whose investment focus in the energy sector may be much broader.

Co-investments are also beneficial to fund sponsors. In terms of expanding their investor base, the test-drive nature of co-investments discussed above can help fund sponsors tap into new sources of capital (particularly with hesitant prospective investors). Co-investments can also help further cement sponsors' relationships with their existing large/other strategic investors as well as other strategic parties such as investment banks who, as a result, may be better incentivized to help the sponsor's business.

Finally, raising co-investment capital can be crucial for the success of primary funds and, as such, beneficial even for those primary fund investors who have limited or no interest in pursuing co-investment opportunities. Often time, a current or prospective portfolio company may have financing needs beyond that which would be appropriate to source from one or more primary funds (e.g., due to primary fund investment restrictions or other over-exposure concerns). Here, absent a sponsor raising co-investment capital, a current investment may not perform as well as it could have with the additional capital sourced from co-investors, and a prospective investment that may have been great for a primary fund may not be possible. Needless to say, co-investments structured via co-investment vehicles allow a fund sponsor to raise capital for an investment program from a broader range of investors without diluting the sponsor's control over a target portfolio company.

Conflicts & Other Governance, Risk, and Compliance (GRC) Considerations

Despite the broad benefits discussed above, there are multiple fiduciary duty concerns associated with the types of conflicts that are inherent to co-investments. These concerns have caused the SEC to scrutinize this area significantly over the last decade. As the SEC's understanding of co-investments has evolved, so has their expectations around how fund sponsors should effectively managed conflicts.

Investment Allocations: Initially, the SEC was concerned about ensuring sponsors had adequately determined that the primary funds in a currently active investment program had satisfied their respective investment appetites for an investment opportunity before offering the overage to prospective co-investors. Under their governing documents, it is typical for such primary funds to be granted first priority over generally all investments within their strategy while in active investment mode.

- **Takeaway:** It is imperative that fund sponsors maintain robust documentation (e.g., via an investment memo or other format) describing the basis for why it was determined that the full amount of an investment opportunity was undesirable for an actively investing primary fund and how the overage amount was calculated. Many fund sponsors do not maintain such documentation and SEC examiners often cite such a shortcoming in their deficiency letters.

Offering Process: Additionally, while it is clear the SEC does not expect any type of current or prospective investor to be, by default, favored in the investment process, it does expect fund sponsors to clearly describe, both in internal policies and procedures, as well as investor-facing disclosures, how they select co-investors and whether certain types of investors will be favored (e.g., those with first rights of offer/refusal via side letter or other contractual arrangement)[10].

- **Takeaway:** Beyond investors with contractual preferential rights, it has become common today for fund sponsors' co-investment policies (and investor-facing disclosures) to enumerate a non-exclusive list of factors they may consider in determining who to offer a first bite at the co-investment apple such as: (i) the ability and track record of the investor to quickly obtain internal approval and fund the co-investment, (ii) the investor's sophistication/experience relating to co-investment (and understanding of co-investment risks in general), (iii) any services an investor is expected to be in a position to provide relating to the co-investment (e.g., strategic advice to the fund sponsor and/or value-add services to the target portfolio company), and (iv) the potential to strengthen the relationship with an investor who may provide long-term benefits to the fund sponsor, its funds and/or portfolio companies.

10 See Section III.B. at https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead

- However, what is a less common (and needed) practice is fund sponsors keeping track of how they implemented their co-investment offering process on a co-investment-by-co-investment basis. This documentation gap has triggered an increase in the number of SEC deficiencies in this area. In some SEC exams, we have seen the SEC ask for multiple specific data points related to the co-investment offering process, which may be difficult to provide years later in the absence of maintaining contemporaneous documentation.
- These data points, which should be maintained in a deal-by-deal co-investment log/tracker, include (i) whether the party to whom the offer was made is an existing fund investor, (ii) type of party (e.g., college endowment fund), (iii) rationale for offer (e.g., party has side letter rights), (iv) size of the co-investment opportunity offered and calculation methodology used, (v) party's response, (vi) different amount (if any) proposed by a party in its response, and (vii) if a party requested less than initially offered, how the excess was allocated to the remaining participants.

Expense Allocations: Further, in more recent years, we have seen the SEC expand its overall expense allocation focus to scrutinize whether co-investment vehicles have received favorable treatment at the expense of primary funds and, if so, whether this was adequately disclosed to primary fund investors. The SEC has taken multiple enforcement actions in this space – all focused on robust disclosure of favorable treatment. While thus far the SEC has stopped short of requiring pro rata allocation of expenses across all participating funds, the SEC's proposed rules from earlier this year seek to mandate such approach in the case of dead deal expenses (with one important carve-out as noted below).

- **Takeaway:** While it is tempting to shield (in part or whole) a smaller co-investment vehicle from an expense drag that would likely be less noticeable and impactful in a much larger primary fund participating in the same deal as such co-investment vehicle, in light of the SEC's examination and enforcement track record in this area, fund sponsors should tread with caution. If an expense cannot be allocated to a co-investment vehicle (i.e., because the co-investment vehicle's governing documents do not permit such an allocation), fund sponsors should consider whether they would need to absorb the pro-rata share of such expense that would otherwise have been allocable to the co-investment vehicle as an over-head expense. This is likely the only permissible approach where an expense is unique to such co-investment vehicle (i.e., in no way directly benefits a primary fund participating in the deal).
- Where the expense is broadly relevant to a primary fund, allocating the entire expense to the primary fund would be less risky if investors in such fund were notified at or prior to investment. Disclosing expensing practices to investors post investment in the closed-end fund space is riskier as it has not been deemed acceptable by the SEC in multiple scenarios (typically based on how material the expense is and overall fairness concerns).
- **Dead deal expense allocations:** When the SEC first started scrutinizing dead deal expenses in the co-investment space several years ago, they noticed that numerous fund sponsors were allocating such expenses entirely to primary funds because co-investment vehicles were typically not organized at the time the applicable deal fell through and, as such, the sponsor had no ability to allocate any portion of such expenses to prospective co-investors. At the time, perhaps given this was a new focus area for them, and the inherent unfairness of requiring managers to absorb investment-related expenses, the SEC was sympathetic to disclosing such expense practice to primary fund investors post-investment. While it is now standard to see such disclosures in ADV filings, they have also become increasingly common in fund governing documents, where primary fund investors agree to such expensing practice prior to investing. It is also notable that, in the adopting release to the proposed private fund reform rules from earlier this year, the SEC indicated such a practice would be permissible, even post adoption of the rules' requirement, that all dead deal expenses be allocated pro-rata to applicable investment advisory clients.

Supplemental Fees: Finally, one conflict where we have seen an increasing scrutiny in the past few years (from investors and the SEC) relates to supplemental fees private equity sponsors get from portfolio companies for various services, such as monitoring and value-add services. The compensation fund sponsors receive for these services has historically not attracted a lot of attention from primary fund investors as they are typically offset against fund management fees (usually on a dollar-for-dollar basis). As a result, in this context, fund sponsors usually have no incentive to seek overly generous supplemental fees.

However, in the co-investment fund context, there are typically no management fees to offset against, so fund sponsors usually get to keep the entire portion of the supplemental fees allocable to co-investment funds. This has caused co-investors to ensure such fees are reasonable so as to ensure portfolio company assets are not being unduly depleted.

Additionally, in this context, primary fund investors are concerned about whether fund sponsors are allocating supplemental fees unfairly away from primary funds, so as to reduce the impact of management fee offsets and allow sponsors to maximize the amount of supplemental fees they get to keep.

Both types of conflicts/abuses have attracted SEC scrutiny in recent years through the examination and enforcement processes and, as such, sponsors managing co-investment funds should very carefully describe, in both internal policies and procedures as well as in disclosures to investors, their supplemental fee allocation processes, what services will be provided in exchange for such fees, as well as how such fees will impact the overall net revenue fee stream for sponsors. For example, if certain types of fees are carved-out from management fee offsets, this should be clearly disclosed. It is also worth noting that as part of the push to increase transparency in the private markets industry, the SEC's proposed rules from earlier this year require sponsors to report to investors the amount of supplemental fees received from any source during the applicable quarter on a quarterly basis.

Exempt Reporting Advisers – Why Building and Maintaining Robust Compliance Programs Has Become Increasingly Important

By Vivek Pingili

Overview of SEC Regulatory Regime

While the Investment Advisers Act of 1940 (the Advisers Act) does not exclude ERAs from the SEC examination process, the SEC has historically affirmed that it does not "anticipate that [it's] staff will conduct compliance examination of these advisers on regular basis," and, instead, would conduct exams based only on indications or suspicions of wrongdoing (so-called "for cause" examinations), which could lead (and have led) to enforcement action in appropriate circumstances. While the SEC may change course in the future and commence subjecting ERAs to routine exams (as its staff has hinted at least on one occasion in the past), "for cause" exams continue to remain the norm in the ERA space for the time being.

ERAs (unlike RIAs) are subject to only a handful of provisions under the Advisers Act. The chart illustrates this concept.

Compliance Obligation	RIAs	ERAs	Other Unregistered Advisers
Fiduciary Obligations	Yes	Yes	Yes
Principal Trade Restrictions	Yes	Yes	Yes
Agency Cross Transactions	Yes	Yes	Yes
Advertising Rule	Yes	No	No
Custody Rule	Yes	No	No
Cash Solicitation Rule	Yes	No	No
Proxy Voting Rule	Yes	No	No
Duty to Supervise	Yes	Yes	Yes
Compliance Rule	Yes	No	No
Code of Ethics Rule	Yes	No	No
Pay to Play Rule	Yes	Yes	Yes
Misleading/Deceptive Conduct Against Investors in Pooled Investment Vehicles (Rule 206(4)-8)) - Encompasses Fraudulent and Decepetive Conduct Done Negligently	Yes	Yes	Yes
Insider Trading Policies and Procedures	Yes	Yes	Yes
Form ADV	Yes	Yes	No
Brochure Rule	Yes	No	No
Systemic Risk Reporting on Form PF	Yes	No	No
Privacy Rule	Yes	No	No
Recordkeeping Rule	Yes	No	No
SEC Examination	Yes	Limited	No
Beneficial Reporting on Schedules 13D and G	Yes	Yes	Yes
Institutional Investor Reporting on Form 13F	Yes	Yes	Yes
Large Trader Reporting on Form 13H	Yes	Yes	Yes
Contractual Requirements (inc. performance fee rest.)	Yes	No	No
Whistleblower Protections	Yes	Yes	Yes

11 See June 22, 2011 Implementing Release to the SEC Registration Exemptions Implemented Pursuant to Dodd Frank at 48. The foregoing Implementing Release is available at: http://www.sec.gov/rules/final/2011/ia-3221.pdf.

While at first glance this may suggest that ERAs' fiduciary duty and other GRC obligations may be very light, this is anything but true. As noted in greater detail below, the overwhelming majority of the SEC's allegations in enforcement actions brought against illiquid fund managers (RIAs and ERAs) over the past few years have focused on allegations of breaches of long-established fiduciary duty concepts applicable to all investment advisers in their dealings with their respective investors (as further codified in the broad anti-fraud provisions set forth in Section 206 of the Advisers Act and Rule 206(4)-8[12] thereunder). As a result, virtually all of the thematic lessons from SEC enforcement actions brought over the years against RIAs employing illiquid investment strategies are broadly relevant to ERAs in the illiquid fund manager space.

Lessons From a SEC Enforcement Action

The SEC took an enforcement action against a state-level venture capital ERA with approximately $13.5 million in investor capital commitments for failure to adequately disclose and manage various conflicts-of-interest (including the related failure to implement the controls set forth in the governing documents of a venture capital fund managed by the ERA that are designed to mitigate these very conflicts). Such a tacking of allegations for failure to operationally comply with conflicts resolution provisions in fund governing documents (and/or internal policies and procedures) onto allegations of anti-fraud rule violations arising out of a mishandling of these very same conflicts, has become a staple feature of SEC enforcement actions in the private markets space.

Additionally, the very fact that the SEC was willing to expend resources to take enforcement action against a state-level ERA should signal to all ERAs how serious the SEC is about vigorously taking punitive action against unregistered private markets investment advisers for activities (or lack thereof) that could have a materially detrimental impact on investors' interests.

The allegations and takeaways from this enforcement action, which should be of wide interest to private markets managers (ERAs and RIAs), are:

» *Failure to establish a limited partner advisory committee in accordance with Fund governing documents:* The governing and offering documents of the Fund managed by the venture capital (VC) ERA required the fund's general partner (an affiliate of the VC ERA) to set up a limited partner advisory committee designed to weigh in on transactions involving the fund and/or portfolio companies on the one hand and the VC ERA and its affiliates on the other hand. However, per the SEC's allegation, this independent committee was not organized for several years into the fund's lifecycle.

  Takeaway: The SEC has repeatedly sanctioned private markets managers (SEC-registered and ERAs) for failure to timely organize and/or adequately involve limited partner advisory committees where required under fund governing documents as the SEC (in line with the industry) views such committees as playing a crucial role, on behalf of investors, in overseeing managers' handling of conflicts. Also, as noted above, both in SEC exams and enforcement actions, the SEC has taken an increasingly keen interest in ensuring that private markets firms are adequately complying with the economic, conflicts-of-interest resolution, corporate governance, and other key terms set forth in fund governing documents and side letters that impact investors' interests. As such, to effectively manage, monitor, and document compliance with such contractual obligations, managers should seriously consider using practice-oriented tools (e.g., spreadsheets or software-based tools) designed to assist in this endeavour. In certain SEC exams and enforcement actions, private markets firms have been required to implement such tools.

12 Rule 206(4)-8 was adopted specifically to protect investors in private funds and its application is very broad, because the rule does not require a showing of scienter (i.e., intent by the adviser to deceive, manipulate, or defraud) or even proof of injury to investors. As evidenced in numerous SEC enforcement actions brought against private fund managers over the last several years, even actions taken (or not taken) by a manager in a negligent manner (as opposed to with an intent to defraud investors) are sufficient to trigger violations of this rule.

» *Failure to provide investors with audited Fund financial statements as required by Fund governing documents:* The governing documents of the fund managed by the VC ERA required the fund's general partner to provide investors with audited financial statements of the fund on an annual basis. However, as alleged by the SEC, the fund's general partner never complied with this requirement, thereby denying investors the protections that come with having a fund's financial statements audited by an independent third-party.

Takeaway: ERAs are not subject to the SEC custody rule that requires RIAs to undertake independent audits of private fund financial statements and deliver the resulting audited financial statements to fund investors. However, given the important protections that come with such independent fund audits, especially in the illiquid fund space, it is very common for investors in such funds to contractually obtain these protections from their investment managers. As evidenced by this enforcement action, the SEC is ready to step in and protector investors where manag

» *Failure to disclose conflicts arising from defaults by the founders:* In an interesting set of facts, a significant portion of investors in the fund managed by the VC ERA defaulted on capital calls issued by the fund's general partner. Of particular note, the VC ERA's founders also partially defaulted on their "skin-in the-game" commitments to the fund. The fund's governing documents provided the fund's general partner with "absolute" discretion to protect the fund's interests by, among other things, demanding payment of the balance due as an interest-bearing loan or forfeiting the defaulting limited partner's distribution rights. However, as alleged by the SEC, the fund's general partner chose not to enforce any remedies against any of the defaulting limited partners, which comprised a majority of the investors and included the founders. The SEC's order found that the decision concerning whether to deem the founders in default presented a conflict of interest that required disclosure to the fund, whether through the non-existent limited partner advisory committee or otherwise. Per the SEC, the conflict "pitted the fund's interest in receiving its committed capital against [the founders'] interest in avoiding being deemed in default and becoming subject to one or more of the punitive actions enumerated in the fund's governing documents.

Takeaway: Given the long-term and captive nature of investments in illiquid close-end funds, virtually all outside investors in closed-end funds expect and demand their fund sponsors have adequate "skin-in-the-game" to ensure the economic and other interests of the investment managers and their key persons on the one hand, and those of the outside investors on the other hand, are appropriately aligned. As such, if a fund sponsor (or its key persons) default on one or more of their capital commitments to a closed-end fund, this is an extremely material development for all outside investors in the fund and failure to disclose such a default would be viewed as a fundamental breach of the fund sponsor's fiduciary duties and a dereliction of its obligations under the Advisers Act's anti-fraud rules. This enforcement action is a reminder that where fund managers neglect such key duties and obligations, the SEC is willing, from an investor protection standpoint, to vigorously take punitive action against such managers to disincentivize such behavior in the future.

» *Failure to adequately disclose and manage conflicts arising from the use of affiliated service provider services:* The offering documents of the fund managed by the VC ERA disclosed that the VC ERA, or its affiliates, may provide services to fund portfolio companies for which they will receive compensation at "competitive market rates charged by first-class unaffiliated service providers," and such services will be disclosed to the fund's limited partner advisory committee. However, as alleged by the SEC, neither the provision of such services to certain fund portfolio companies by the VC ERA's controlling persons through a service provider controlled by such persons, nor the fact that such control persons caused the fund to invest in such affiliated service provider were disclosed to the fund's investors or the fund's limited partner advisory committee for several years.

Takeaway: The SEC has, on numerous occasions, sanctioned RIAs and ERAs in the private markets space for failure to adequately disclose and implement controls around the use of affiliated service providers, even when no damage to investors may have occurred – either privately via the examination process or publicly via the enforcement process. This is a reflection of the SEC's view that such arrangements inherently involve material conflicts (i.e., self-dealing risks). To effectively manage regulatory risks, firms should disclose such arrangements to all investors as early as possible. Given the long-term and captive nature of investments in closed-end funds (where investors may be at the mercy of their managers for over a decade), the SEC seems to strongly prefer that conflicts be disclosed to investors prior to their investment in the applicable fund(s) whenever feasible.

Additionally, to the extent an affiliated service provider arrangement was not contemplated prior to the launch of a closed-end fund, based on ACA's SEC examination experience, seeking the informed consent of the fund's limited partner advisory committee, and meaningfully disclosing key aspects of such an arrangement (including, but not limited to, proposed fees) to all fund investors prior to implementation, will be especially important.

Further, prior to retaining an affiliated service provider and periodically thereafter, managers should conduct surveys in the relevant markets to determine what comparable quality independent third-party vendors charge for similar services and factor the results of such surveys in setting and periodically adjusting the compensation to be received by their affiliated service providers. Such survey results should, at a minimum, be disclosed to the applicable fund's LP advisory committee to ensure their consent to/review of affiliated service provider usage is meaningful and informed. Evidence of undertaking such surveys is frequently requested in SEC exams to verify that affiliated service arrangements are being undertaken on an arms-length basis. Additionally, even where firms appear to have, as a matter of practice, undertaken all the right steps to effectively manage conflicts relating to the use of an affiliated service provider, in numerous exams, the SEC has pushed such managers to formally adopt policies and procedures to ensure consistency in approach over the duration of the conflict as well as to facilitate testing adherence to such policies and procedures on a retroactive basis.

Finally, to the extent a manager's affiliated service provider seeks to receive higher than market rates under the argument the affiliate is seeking to provide white glove services and/or services that are not fully available in the relevant markets (such that a pure apples to apples comparison is not possible), the justification for such premium pricing should be adequately documented and disclosed.

Conclusion

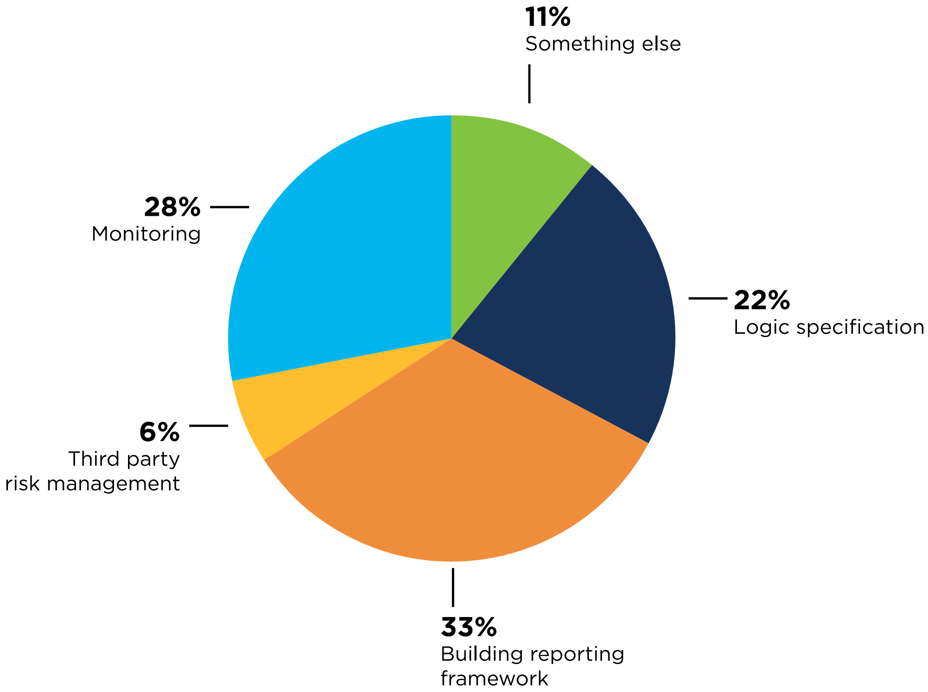
As fiduciaries that may be subject to SEC inspection (and that are being increasingly subject to SEC enforcement action), ERAs should consider adopting compliance policies and procedures relevant to their operations to mitigate regulatory risks. Similar to compliance programs for comparable SEC-registered advisers, these policies and procedures should be designed to prevent violations from occurring, detect and document violations that have occurred, and promptly address any violations that have occurred.

Emerging Threats in the Cyber Landscape

By John de Freitas

Financial services firms (including private markets fund managers) have good reason to be worried about cyber risk. Overall, there was a 68% rise in breaches from 2020 to 2021, according to the **Identity Theft Resource Centre**. The average total cost of a cybersecurity breach for a financial services firm is now $5.72 million, says the **IBM Cost of a Data Breach Report**. It's not surprising that financial services regulators are responding to this by launching new measures for greater oversight. Financial services firms are responding in a number of ways to this evolving landscape.

Your firm has fallen victim to a ransomware attack, do you pay the ransom?



Cyber Threat Trends

Half of the financial services firms responding to a recent survey conducted by ACA Group said the increase in occurrence and sophistication of threats, such as ransomware, concerned them the most. It's easy to see why – the sophistication of the attacks and the availability of the malware to download means firms are experiencing a greater number of attacks, that are becoming more difficult to repel. The kinds of attacks firms are seeing more of include:

» **Ransomware** – According to the **ACA-NSCP 2021 Cybersecurity Program Survey**, 83% of firms are "moderately" or "extremely" concerned about ransomware. It's interesting that more than 56% of respondents said their firm may pay the ransom, depending on the data that was encrypted. However, it's important to note that paying the ransom can encourage repeat attacks. New forms of ransomware are emerging and using new tactics, such as the triple threat, where the criminals encrypt the firm's data, threaten to release that data to the public, and then also threaten to tell all the firm's suppliers, third-parties, and customers that it's been hit by ransomware.

» **Third-Party/Supply Chain Attacks** – Regulators are very aware of the potential threat to financial firms through third-party attacks.

» **Business Email Compromise** – Attackers are becoming more sophisticated here too. Now they will send a business email that looks like it's from someone an individual trusts, such as someone they may have a long business relationship with. Training staff to look for suspicious clues is important in preventing these kinds of attacks.

» **Distributed Denial of Service Attacks** – These attacks flood a website from multiple points of origin, making it really challenging to stop the attack. Today it's very easy to access the programs to launch such an attack on firms – even the big internet companies are struggling to prevent these kinds of attacks.

Overall, the attack environment for firms continues to grow more challenging. With the current conflict in the Ukraine, the potential for state-sponsored cyber warfare has also increased.

Cyber Regulation Trends

Regulation around the globe for cyber risk is increasing, and the pace of regulatory change is likely to accelerate further as jurisdictions implement specific cybersecurity rules and personal data protection requirements along the lines of the EU's General Data Protection Regulation (GDPR). Three sets of requirements that firms should be preparing for today include:

- **The SEC's Proposed Cybersecurity Risk Management Rules** – These published **proposals** would impact U.S. registered investment advisers, requiring much more stringent governance, reporting, and documentation. Another noteworthy new requirement is the reporting of a significant breach to the SEC within 48 hours.
- **The EU's Digital Operational Resilience Act** – Otherwise known as DORA, this set of proposals has a large range of financial institutions in scope, including alternative investment management firms. DORA draws many of the existing operational resilience rules in different EU countries together, and contains many of the themes that are in the SEC's new proposals. The rules are expected to be finalized this year, and there will probably be a transition period for implementation, similar to what happened with GDPR.
- **Personal Information Protection Law (PIPL)** – This law, which came into **effect** in November 2021, is essentially China's version of GDPR. And much like GDPR, if a firm is offering services to individuals within China, it must comply with PIPL.

For financial firms, cyber risk includes both regulatory risk – that is, the risk of regulatory change – as well as compliance risk. Firms need to think strategically about the actions they take to comply, and how they evidence this compliance.

Cyber Program Trends

Firms are fighting back against the cyber risks they are facing in a variety of ways. Four key ways in which they are taking action include:

- **Third-Party Risk Management** – Regulators around the globe are paying more attention to third-party risk management (TPRM), in part because of the increased cyber risk these non-regulated businesses pose to financial services firms. Cyber risk management teams should be working very closely with TPRM teams to understand which vendors work with the organization, what data they process, and which systems they may have access to. Firms also need to consider how closely the organization relies on these companies from an operational resilience perspective. If there is an incident, the firm and the third-party should have an operational resilience plan in place, particularly if the company contributes to an important business process. When the relationship ends, what happens to the data and system access should be written into the contract up front.
- **Incident Response/Business Continuity Planning** – Firms should have a documented plan in place for managing a cyber-attack incident, and employees should be trained in their role in the response. It's important to test these plans at least once a year through the use of tabletop exercises, and to also perform business continuity testing annually, or when circumstances change significantly.
- **Cloud Migration/Security** – Firms have moved substantial amounts of data and information processes into the cloud since the beginning of the COVID-19 pandemic in 2020. However, having data in the cloud is not risk free. Firms should regularly review what data they are storing in the cloud, where it is stored, who has administrator rights, and what their configuration is, because misconfiguration can leave a firm exposed. Firms should consider reviewing the configuration of their cloud environments on a periodic basis.

Additional Insights

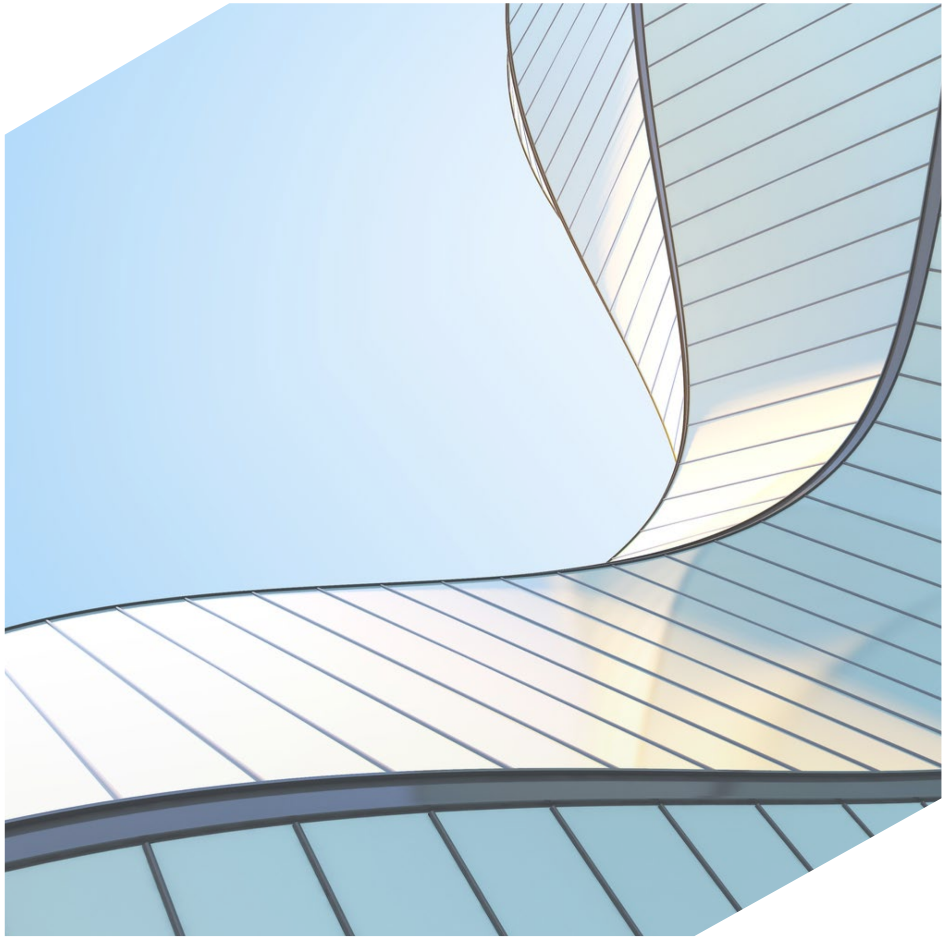
For additional insights, please **click here** to watch a recording of a session on cybersecurity risk trends we did earlier this year with Apax Partners.

ACA Group Unveils Outsourced Chief Compliance Officer Practice

We are happy to announce that we launched a dedicated outsourced chief compliance officer (OCCO) practice for the financial services industry.

The OCCO practice was formerly operated under Foreside prior to its merger with ACA in May, and has been relaunched with ACA to serve the unique needs of various financial services firms, such as hedge fund, private equity, wealth and asset management, broker dealers, and more. The practice brings a hybrid approach to compliance, driven by a deep bench of former regulators, CCOs, and compliance personnel and enabled by innovative regulatory technology. Through this practice, firms are assigned a singular CCO from ACA who assumes the responsibility of overseeing compliance duties on their behalf.

Read more about this service **here**.



About ACA Group

ACA Group ("ACA") is the leading governance, risk, and compliance (GRC) advisor in financial services. We empower clients to reimagine GRC and protect and grow their business. Our innovative approach integrates advisory, managed services, distribution solutions, and analytics with our ComplianceAlpha® regulatory technology platform with the specialized expertise of former regulators and practitioners and a deep understanding of the global regulatory landscape.

Our global team of regulatory compliance professionals includes former SEC, FINRA, FCA, CFTC, NFA, and state regulators, as well as former senior managers from prominent financial institutions and advisory firms. We work with compliance and legal professionals to review and develop compliance programs based on best practices, current regulatory requirements, and robust oversight processes.

For more information, visit
www.acaglobal.com

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Tanner Beverly

Tanner Beverly is a Senior Principal Consultant with the ACA Performance Services division, and has been with ACA Group since 2017. Tanner leads GIPS® verifications, performance certifications, and focused reviews primarily within alternative asset classes such as private equity, private credit, and commercial real estate.

Prior to ACA, Tanner worked as a portfolio accounting system administrator and investment adviser representative. Tanner holds the Chartered Alternative Investment Analyst (CAIA) and Certificate in Investment Performance Measurement (CIPM) designations.

He earned his Bachelor of Science degree in Finance from the University of Tennessee at Chattanooga.

Erika Chua

Erika Chua, CFA, joined ACA in October 2012 and now serves as a Director. She coordinates and participates in annual compliance program reviews, performs mock SEC inspections, conducts focused reviews of client-specific risk areas, and provides ongoing compliance support to ACA clients.

Erika's work experience prior to joining ACA includes accounting, management, compliance, and human resources responsibilities in several nonprofit organizations. Erika earned her B.S. in Business Administration and Master of Public Administration from the University of Southern California.

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John de Freitas

John is Senior Principal Consultant at ACA Aponix), the cybersecurity, privacy, and IT risk division of ACA Group. In this role, John provides comprehensive cybersecurity and risk services to clients from across the hedge fund, private equity and investment banking space to help build and maintain bestpracticealigned programs to tackle emerging cyber threats and meet regulatory obligations.

Before joining ACA, John was an information security analyst at Winton Group (Winton), a leading global hedge fund, where he was responsible for security risk management and vendor due diligence. At Winton, he helped establish their formal cybersecurity awareness program, which was built around in-person training, online advisory materials, and ethical phishing programming.

John earned his Bachelor of Science degree in computer science from the University of Salford in Manchester.

Adam Palmer

Adam Palmer is a Partner with ACA Group in the the United Kingdom. In this role, he maintains a portfolio of clients and manages a team of consultants providing Financial Conduct Authority (FCA) and U.S. Securities and Exchange Commission compliance support to UK-regulated companies.

Immediately prior to joining ACA, Adam worked for the Permal Fund of Funds Group. While there, he focused primarily on the company's UK, Dubai, Hong Kong, and Singapore regulatory requirements. Before Permal, Adam served as Vice President, Legal and Compliance, for Centaurus Capital, a European event-driven hedge fund. In that position, he handled all UK and European regulatory issues and oversaw implementation of Hedge Fund Standards Board requirements.

Previous to this, Adam held managerial and senior consultant positions at a leading UK compliance consultancy. There he specialized in providing technical regulatory analysis and compliance support to hedge fund investment managers.

Adam started his career at Fidelity Investments in the UK. In previous employment, he earned the UK Regulator's approval to perform compliance oversight and money-laundering reporting functions for UK-regulated firms.

Adam earned his Master's in Commercial and Corporate Law (LLM) (merit) from University College London, having previously graduated in Law and Politics from the University of Birmingham. He also holds the Investment Management Certificate. He contributes frequently to industry journals and news services on UK and European regulatory subject matters. In addition, Adam has participated in industry working groups established by the Alternative Investment Management Association.

About the Authors

Vivek Pingili

Vivek Pingili is a Director of ACA's Private Funds Practice and focuses on corporate governance, operational and regulatory compliance matters relating to private markets investment managers. As a private markets specialist, Vivek helps a broad range of domestic and international private markets investment managers (including venture capital, private equity, private real estate, private credit, and private equity fund-of-funds managers) successfully implement and maintain comprehensive regulatory and operational compliance programs (including joint FCA and SEC compliance programs). Vivek also helps clients prepare for SEC audits.

Prior to joining ACA, Vivek was senior counsel in the Private Investment Funds practice group at Proskauer Rose LLP. While at Proskauer, Vivek represented a broad range of illiquid asset managers, including managers of buy-out funds, secondary funds, venture capital funds, private real estate funds and fund-of-funds, in regulatory compliance matters as well as in connection with the structuring, formation, offering and ongoing operations of such funds.

Prior to Proskauer, Vivek was head of legal and compliance for the global private markets business at Russell Investments, one of the largest global asset managers. While at Russell Investments, Vivek managed the legal and compliance program for the firm's global private markets business unit (specializing in private real estate, venture capital and private equity strategies).

Prior to joining Russell Investments, Vivek was a senior attorney in the Private Investment Funds practice group at Ropes & Gray LLP. While at Ropes, Vivek represented a broad range of private markets fund managers in regulatory compliance matters as well as in connection with the structuring, formation, offering and ongoing operations of such funds. Vivek also represented numerous U.S. and non-U.S. institutional investors, including state, corporate and non-U.S. pension funds, college and university endowments, sovereign wealth funds and fund-of-funds in connection with their investments in private funds and separately managed accounts operated by a broad array of private markets investment managers.

Vivek received a J.D. from Northeastern University School of Law and a B.A., magna cum laude, from Brandeis University.

About the Authors

Neha Pasricha

Neha Pasricha is a Principal Consultant within the ACA's Investment Advisor team. Neha assists with providing on-going compliance consulting support to clients including but not limited to the SEC registration and updates to the regulatory filings such as Forms ADV, 13F, 13H, Form D and NFA filings. She also assists clients in developing and implementing compliance policies and procedures. In addition to oversight of personal trading activities and Code of Ethics, her responsibilities also include performing annual compliance reviews and training.

Prior to joining ACA (formerly Cordium) in 2014, Neha worked for PNC Financial Services Group, Inc. (formerly Mercantile) in Baltimore as a Business Analyst and then as a Compliance Specialist. She also served as the Law Clerk to The Honorable Michael Blee, J.S.C. in New Jersey.

Neha holds a J.D. from Rutgers School of Law as well as a Bachelor of Science in Information Systems Management from the University of Maryland, Baltimore County (UMBC).

Andrew Poole

Andrew Poole is Director at ACA Group. In this role he oversees and lead numerous client engagements, predominantly in the Private Markets space encompassing Private Equity and Private Credit/Direct Lending sectors.

Prior to this Andrew was the European compliance officer at Ares Management Limited in London, where he conducted compliance oversight (CF10) and money laundering reporting (CF11) activities for the European business. Before this, he was risk and operations manager at Secquaero Advisorsr. In that role, he established the operational, compliance, and risk surveillance procedures for all investment funds, developed several products, including UCITS and Guernsey fund structures, and oversaw FX hedging. He then became head of risk and compliance in Europe for US Bank Global Corporate Trust Services. There he served as chairperson of the new business acceptance committee, developed and implemented the firm's risk and compliance strategy and framework, and supervised the development of AML/CTF procedures and approvals. He also advised on the application and implementation of MiFID and AIFMD and served as the point of contact for regulators such as the Central Bank of Ireland, the Federal Reserve, and the Financial Services Authority.

Andrew has also held roles as assistant vice president at Andrew then moved to Partners Group, Product Manager at RMF/Man Investments, Head of CDO/Loan Compliance at RMF/Pemba Credit Advisors and middle office trading and sales at CFSB in Zurich

Andrew earned his Bachelor of Science degree in Genetics at the University of Newcastle Upon Tyne. He also speaks fluent German.