HIGHLIGHTS FROM

Annual Rocky Mountain Private Fund Advisers Summit

On Dec. 4, 2019, Bryan Cave Leighton Paisner LLP, MG Stover, RSM LLP, and the University of Colorado School of Law co-hosted the annual Rocky Mountain Private Fund Advisers Summit in Denver. More than 60 industry professionals and others attended. Panels of industry specialists explored current Securities and Exchange Commission ("SEC") perspectives on regulation, the marketing of private fund interests to potential investors, fund formation and ongoing operations, and emerging trends in funds. The following summarizes key discussion points from the panels.

STRAIGHT FROM THE SOURCE: SEC PERSPECTIVE ON REGULATION

Kurt Gottschall, Associate Regional Director for Enforcement at the SEC's Denver Regional Office ("DRO"), was interviewed by Cliff Stricklin, a Partner at Bryan Cave Leighton Paisner LLP and an Adjunct Professor at the University of Colorado School of Law. Mr. Gottschall oversees the Denver Regional Office's enforcement investigations and litigation in a seven-state region.

Mr. Gottschall discussed certain private fund manager practices that have led to recent SEC enforcement actions, including: (1) misallocation of fees and expenses, (2) undisclosed compensation, (3) conflicted and affiliated transactions, and (4) asset valuations.

As to fee and expense allocations, Mr. Gottschall noted recent SEC actions involving private fund sponsors allocating to their funds fees and expenses that are either not properly disclosed, or otherwise fall outside of the allowable expenses outlined in, the fund's offering and governing documents. He discussed as an example the SEC's December 2018 enforcement against private fund manager NB Alternatives Advisers LLC ("NB Alternatives"). The SEC sanctioned NB Alternatives for charging its private funds for the compensation of a group of employees who, while paid by the funds to provide support and advice exclusively to fund portfolio companies, also spent part of their time working on behalf of NB Alternatives. He also discussed a recent SEC enforcement action against Lightyear Capital LLC ("Lightyear"), a private fund sponsor for allocation issues related to co-investments, including for failure to disclose that broken deal and legal expenses associated with certain investments would be allocated to one of its funds and not to participating co-investors. (A discussion of the Lightyear enforcement action can be found HERE in the May 2019 edition of "*The Adviser*" by Bryan Cave Leighton Paisner LLP).

With respect to compensation, Mr. Gottschall stated that the SEC is not looking to second-guess compensation that fund advisers or their affiliates receive from their funds, but to ensure that the compensation arrangements are adequately disclosed to investors. He described, as an example, the SEC's April 2018 enforcement action against private fund adviser WCAS Management Corporation ("WCAS"), where the SEC sanctioned WCAS for failing to disclose its agreement with a service provider to its funds' portfolio companies that provided for WCAS to receive a share of the revenues paid to the service provider in connection with portfolio company purchases. He also discussed actions involving accelerated monitoring fees without proper disclosure, including the SEC's June 2018 enforcement action against THL Managers V, LLC and THL Managers VI, LLC.

Mr. Gottschall added that, locally, he is seeing more investigations and actions involving real estate funds, where a fund will buy real estate property and then engage entities affiliated with the fund sponsor to provide various property-related services. He stated that these types of arrangements, where funds or fund portfolio companies/properties engage service providers affiliated with the fund's manager, must be properly disclosed to fund investors.

Mr. Gottschall then addressed conflicted and affiliated transactions. He discussed the September 2019 enforcement action involving Impact Opportunities

Fund Management LLC ("IOFM") and its sole managing member (the "IOFM Manager"). He explained that, in this action, the SEC alleged that:

- The IOFM Manager and a business partner had defrauded investors of Cobalt Sports Capital, LLC ("Cobalt"), an entity they formed to loan money to professional athletes, by causing Cobalt to make undisclosed loans to struggling portfolio companies owned by Impact Opportunities Fund, L.P. ("IO Fund"), a private fund managed by the IOFM Manager through IOFM;
- The IOFM Manager and IOFM had defrauded IO Fund investors by charging the IO Fund undisclosed monitoring fees, a portion of which went to the IOFM Manager; and
- The IOFM Manager had defrauded another private fund and its investors through two advisers he controlled by causing the fund to purchase Cobalt, which caused the fund to breach its concentration limits, and by falsely valuing the fund's investment in Cobalt in reports to fund investors, effectively concealing the concentration limit breaches.

With respect to valuations, Mr. Gottschall emphasized that the SEC is aware of how difficult it can be to value illiquid or thinly-traded assets, and is not looking to interpose itself into valuation decisions or models. Rather, he stated that the SEC seeks to ensure that fund managers are valuing fund assets in a manner consistent with their stated valuation policies and procedures and disclosures, and that fund managers are not engaging in active fraud in valuing fund assets.

He then discussed the SEC's May 2018 complaint against Premium Point Investments LP ("Premium Point"), where the SEC charged Premium Point and certain of its officers with engaging in a scheme to pump up their fund's poor performance by arranging for a broker-dealer to provide inflated price quotes for the fund's mortgage-backed securities in exchange for Premium Point's promise to direct trades to the broker.

Mr. Gottschall also discussed the SEC's September 2019 complaint against hedge fund manager SBB Research Group, LLC ("SBB") and its two top executives, in which the SEC alleged that—despite telling fund investors that they valued the funds' structured notes at "fair value"—SBB and its executives instead used their own valuation model, which artificially inflated the value of the funds' structured notes and caused SBB to misstate the funds' historical performance and overcharge investors approximately $1.4 million in fees.

Finally, Mr. Gottschall discussed the SEC's November 2019 proposed amendments to the advertising and cash solicitation rules adopted under the Investment Advisers Act of 1940 ("Advisers Act"). He explained that the proposed amendments to the Advisers Act's cash solicitation rule (Rule 206(4)-3), if adopted as proposed, would extend the rule to cover the solicitation of private fund investors (the current rule technically only applies to the solicitation of "clients" and not to investors in funds managed by the adviser).

****Mr. Gottschall cautioned the audience that his comments and opinions (as described above) are solely his own and do not reflect the formal or informal comments, opinions, and policies of the SEC.****

STRATEGIES FOR ATTRACTING AND RETAINING INSTITUTIONAL INVESTORS

This panel discussed strategies for raising capital from institutional investors. Mark Weakley, Co-Leader of the Private Fund Practice at Bryan Cave Leighton Paisner LLP, moderated the panel. The panelists were Ryan Castle, Managing Director at JCR Capital Investment Corporation, Chris Jacoby, Senior Vice President in the Private Capital Group of AMG National Trust Bank, Kyle Rogers, Chief Operating Officer at Delta-v Capital, and Chuanbi Xu, Investment Manager at Partners Group.

Ms. Xu kicked off the panel by suggesting that, in her experience, there are three T's that institutional investors focus on: 1) track record, 2) team, and 3) time. Ms. Xu noted that, in her experience, a track record of established net returns and a continued display of team-oriented cohesiveness, each showcased over time, convey trust to institutional investors which is a crucial element of attracting their capital. Mr. Castle observed that the investments of most private fund managers have succeeded in the recent bull market, which makes it difficult to convince institutional investors to allocate away from existing managers. As such, Mr. Castle suggested that unique or specialized products are keys to successfully tapping into the institutional investor market.

Mr. Rogers concurred with Ms. Xu and Mr. Castle on the importance of differentiated products and a track record of net returns are important to institutional investors, emphasizing the ability to generating attractive returns consistently. Mr. Rogers also stressed the importance of continually sharpening the pitch to institutional investors. Finally, Mr. Jacoby recognized that a fund manager's relationship with institutional investors is typically long-term, and noted that it is necessary to know investors and tailor investment strategies and team structures accordingly.

Mr. Weakley next posed to the panel the following fill-in-the-blank question: "Institutional investors ask for it anyway, so you might as well ______." Mr. Jacoby noted that institutional investors often desire and require full transparency, including cash flow projections, so fund managers should be prepared to provide an answer to every question on those matters. Mr. Rogers suggested that, in his experience, institutional investors can focus heavily on operations, well beyond the fund's investment strategy. As it relates to institutional investors' due diligence request lists, Mr. Rogers suggested obtaining one in advance to aid in preparing effective responses and to build the fund's operations in anticipation of seasoned investors' diligence questions. Mr. Castle noted that his goal is to hold firm on those requests relevant to his funds' investment theses while producing upfront the information that is requested more often, such as IT security and succession plans. Ms. Xu wrapped up the panel's discussion on this question by discussing how fund managers should prioritize implementing scalable processes in order to balance the comprehensive requests from institutional investors with the fund's desired core competencies.

The panel next discussed key market trends. First, the panelists discussed management fee structures. Mr. Castle, Mr. Rogers and Ms. Xu each shared their observations on the increasing pressure from institutional investors to pay management fees on invested capital, not committed capital, and how institutional investors are growing more resistant to not paying fees on large, unallocated capital account balances. Mr. Rogers noted that this resistance from investors puts constant pressure on funds to deploy capital, which can prove costly for the fund. Mr. Rogers and Mr. Castle suggested some of the more creative fee structures to ease some of this pressure, including deferring the collection of management fees for 12 to 24 months following a fund's initial closing. Mr. Jacoby noted that the pressure on management fees varies by asset class. For hedge funds, he believes that fee structures are moving away from the traditional 2/20 split to a 1.5/15 split; however, a 2.5/25 split can still be seen with smaller venture capital funds. Given the pressure on management fees and the different ways to calculate them, fund managers should be prepared to justify why their proposed management fee structure makes sense for their funds' strategies.

The panel then addressed co-investments, and acknowledged the universal demand for capital to be deployed with lower fees. Mr. Rogers discussed the use of a pool of co-investment vehicles with lower fees to meet some of this demand.

The panel concluded their discussion by sharing their own best practices in managing side letters. Mr. Castle noted the usefulness of implementing a systemic approach when dealing with a larger number of side letters. Mr. Castle and Mr. Rogers also observed the balancing act that is required to navigate a fund's capital pipeline and discussed as one possible strategy trying to stay flexible on economic points with anchor investors while giving less flexibility to non-anchor investors.

KEY CONSIDERATIONS ON FUND FORMATION AND ONGOING OPERATION

Dan Mohrbacher, CPA, Partner of RSM, moderated the panel. Dee Anne Sjögren, Partner of Bryan Cave Leighton Paisner LLP, Jason Lunte, Senior Tax Manager of RSM and Josiah Reich, Chief Financial Officer of MG Stover, provide their views on recent trends in fund formation and ongoing operation.

Creative Fund Structures. Dan asked for a summary of trends where fund managers are being creative in structuring funds in an attempt to attract new and different types of investors, to provide liquidity and/or to provide tax advantages. Dee Anne noted that her firm has seen an increase in new types of open end real estate funds, as well as series LLCs that allow a committed pool of investors or family office clients to invest in real estate opportunities on a project-by-project basis. Dee Anne shared a novel private fund

liquidity approach she recently worked on, a "matching program" in a real estate fund. Here, fund investors seeking liquidity for their fund interests are matched with interested buyers. Josiah also related that closed-end funds seeking to provide liquidity features face considerable risk of losing the liquidity optionality when the fund's own positions become illiquid.

Tax Reform. Dan asked whether, one year after the effective date of The Tax Cuts and Jobs Act ("Jobs Act"), there have been any popular structuring trends as new funds are being launched, and whether there are important factors for fund managers to consider related to tax reform. Jason noted that although there has been substantial buzz about Opportunity Zone funds, his firm has seen only a limited number of funds launched due to the heavy tax compliance burden on fund managers and 10-year lock-up period. Josiah added, that as fund managers become more and more creative in structuring their funds, it's importance to involve the administrator and audit/ tax early in the structuring process to help consult on logistical challenges and costs. Jason went on to add that the Jobs Act's impact on private funds has been more at the operating company level, than the fund level, including as a result of the 20% tax pass-through deductions for individual investors, the lowering of the corporate tax rate to 21% and leaving in place the favorable tax treatment of qualified small business stock.

Competitive Environment. Dan shifted gears to discuss the competitive environment that currently exists for private funds. He noted that competition for investor capital remains extremely high with a wide variety of investment options.

- Types of Funds – Dan asked the panel members whether, over the past year, there have been trends seen with clients/ prospective clients related to increases in certain types of funds/ investment strategies. Dee Anne noted that venture capital and real estate funds were the most dominant, while she has seen very few hedge funds launched given the strong equity markets. She has also observed fund managers trying to compete through more creativity, such as single asset vehicles, more foreign investors particularly in real estate funds, family offices seeking to form private equity and debt funds, and an increasing use of series limited liability companies where investor choose whether or not to participate in particular investments.
- Competitive Advantages - Dan asked what fund managers are doing to attract investors into their pooled vehicles, including:
  - Side Letters – More common/less common/about the same? Josiah noted that his firm has seen a trend in investor demands for increased reporting; and
  - Fee changes and trends/downward trend to attract investors? Dee Anne noted that private equity fund managers appear willing to negotiate management fees and carried interest for larger investors, which can create a huge burden on asset managers.
  - Investor incentives such as SPVs/co-investments:
    - Pros - Josiah noted that SPVs and co-investments allow investors to pick and choose investments, to be more selective, to diversify, and to invest at a lower cost, while they allow managers to raise capital on a deal by deal basis. Dee Anne noted that she has seen fintech managers reserve co-investment rights to industry executives who provide deal flow.
    - Cons - Josiah noted that SPVs and co-investments result in reduced compensation for fund managers and increased legal and compliance costs.
  - Josiah and Jason noted that outside services providers can assist fund managers by hiring additional internal support (such as data security resources) and investing in technology solutions (such as offering web-based investor portals for fund investors).

New Fiduciary Duty Rule. Dee Anne noted that the SEC had issued its final interpretation of an adviser's "fiduciary duty" to clients, which is enforceable under the antifraud provisions of the Investment Advisers Act, and summarized the provisions applicable to private fund advisers that are SEC-registered advisers as follows:

- *Contractual Relationship Governs.* She noted that the SEC confirmed that an adviser's fiduciary duty would be viewed in light of the agreement negotiated between the adviser and the client (e.g., the private fund's LP Agreement or LLC Operating Agreement).

- *No Waiver of Fiduciary Duty.* She noted that the SEC has taken the position that a general waiver of the fiduciary duty is "inconsistent with the Advisers Act, regardless of the sophistication of the client," and provided the following specific examples of contract provisions that purport to waive the adviser's fiduciary duty: (1) a statement that the adviser will not act as a fiduciary; (2) a blanket waiver of all conflicts of interest; or (3) a waiver of any specific obligation under the Advisers Act.
- *Duty Not to Subordinate Client's Interest.* She explained that the SEC has stated that an adviser's fiduciary duty includes a duty of loyalty that would prevent the adviser from placing its own interests ahead of the interests of its clients.
- *No Duty to Eliminate or Avoid Conflicts.* She noted that the SEC confirmed that advisers are not required to eliminate or avoid conflicts, although the SEC cautioned that advisers must "address the conflict by providing full and fair disclosure such that a client can provide informed consent to the conflict" and that, in order for disclosure to be full and fair, "disclosure of a conflict must be sufficiently specific so that a client is able to understand the material fact or conflict and make an informed decision whether to provide consent." As a result, she recommended that private fund advisers avoid broad pre-dispute waivers and instead provide specific disclosures of material conflicts of interest.

EMERGING TRENDS IN FUNDS

This panel discussed recent private fund trends, including general new developments as well as investment categories such as blockchain, cryptocurrency, cannabis, ESG/impact and opportunity zones.

Gary Newlin, a Director at MG Stover, moderated the panel. The panelists were Eric Gerding, a Professor at the University of Colorado Law School, Jason Kuruvilla, a Partner and Financial Services Senior Analyst, at RSM LLP, and Riley Combelic, an Associate in the Private Funds practice at Bryan Cave Leighton Paisner LLP.

Mr. Newlin began by posing the question of "if a fund manager is going to launch a fund, what are you seeing that's outside the box?" Mr. Combelic observed that first-time fund managers should maximize their ability to attract investors through sufficiently creative and narrow strategies. Investors, he notes, are amenable to emerging managers who offer unique investment strategies. This may also attract non-US investors who tend not to invest with US emerging managers absent a unique and compelling strategy.

Mr. Kuruvilla noted that managers launching new funds need to keep in mind the impact of the Tax Cuts and Jobs Act on taxes related to management fees and carried interest: that is, fund investors may no longer deduct management fees paid to the fund manager, and the carried interest or incentive allocation paid to general partners or investment managers will qualify for taxation at long-term capital gains rates only if a fund holds the relevant investments for at least three years.

Mr. Combelic add that the private fund industry is seeing more activity in the secondary fund market – new funds formed to purchase funds at the tail end of their existence, either through a restructuring (e.g., a new fund is formed to purchase assets from an existing fund, and the investors in that existing fund rolling over to the new fund); or a new fund purchasing the remaining assets of funds attempting to wind up and dissolve. Mr. Combelic believes restructuring of funds in the middle of their terms will increase as the economy will inevitably experience a down-turn.

Professor Gerding commented that the SEC appears poised to expand private securities offerings through a recent concept release ("Harmonization of Securities Offerings"), a good portion of which is devoted to pooled investment funds. The concept release can be found HERE and the discussion on pooled investment funds begins on page 172 of the release. Continuing on the SEC's activities related to securities offerings, Professor Gerding highlighted the SEC's announcement of its intention to amend the definition of "accredited investors". The SEC's release can be found HERE. Professor Gerding said he expects to see a strong push by the SEC to propose the new rules by this Spring.

Mr. Kuruvilla shared his belief that the SEC's Chair, Jay Clayton, will seek to expand the ability of investors to obtain exposure to alternative asset classes such as investments in private funds, although not necessarily expanding that access to "retail" investors. Rather, he

believes the focus will be for institutional and high net-worth individuals to have better opportunities to invest in private funds.

Mr. Newlin then asked the panel to address regulatory and compliance issues related to private funds that invest in cryptocurrencies. Panel members acknowledge that this asset class remained of interest to private fund managers, but hat the industry is still waiting on the SEC to provide better guidance on when a cryptocurrency is considered a "security" as opposed to, say, an initial coin offering. The SEC has been relying thus far on the "Howey Test" in making that determination (*SEC v. Howey*, decided by the U.S. Supreme Court in 1946, a link to which can be found HERE). It was noted that whether a cryptocurrency is a security or not has significant regulatory and compliance considerations for private fund advisers (e.g., sale of unregistered securities, broker-dealer issues, and compliance with other securities laws and regulations, including the federal Investment Advisers Act of 1940 and state law counterparts, as well as the federal Investment Company Act of 1940).

The panel then discussed how technology is impacting investment managers. Mr. Kuruvilla cited as one example that asset managers are collecting actionable data from a variety of sources to use as an edge investment decisions. Mr. Newlin noted that blockchain technology is supporting such solutions as automating the filling fund subscription agreements by investors.

The panel concluded with a brief discussion on additional strategies they expect to continue to expand included ESG (Environmental, Social and Governance.) and impact funds, women-led funds and investments in women-led businesses and opportunity zone funds. As to opportunity zone funds, the panel noted that the uncertainty surrounding the longevity of the OZ tax benefit is resulting in fewer funds devoted to opportunity zones. If the OZ program is extended by Congress, then the panel expects to see renewed growth in that sector.

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