

## Session II

# Private Fund Developments

Andrew Fagenholz, Managing Counsel, Cambridge Associates

Pamela A. Grossetti, Of Counsel, K&L Gates LLP

Nicholas S. Hodge, Partner, K&L Gates LLP

Rick Lake, Chief Investment Strategist and Head of Distribution, F/m Acceleration LLC

*Moderator: Kenneth Holston, Partner, K&L Gates LLP*





# RECENT SEC ENFORCEMENT ACTIONS

## FEES AND EXPENSE ALLOCATIONS

### **ECP Manager** (Sept. 27, 2019) *Administrative Proceeding File No. 3-19535*

- A PE adviser settled claims which alleged that it caused its fund to overpay management fees three times, for a total of \$102,304, by failing to exclude from the management fee calculation amounts attributable to certain written-off assets, despite the fund's governing documents providing those amounts would be so excluded.
- The SEC ordered the adviser to pay disgorgement plus interest of \$122,656 and \$75,000 in penalty.

### **Corinthian Capital** (May 6, 2019) *Administrative Proceeding File No. 3-19159*

- A PE adviser settled claims which allege that it failed to apply a \$1.2 million fee offset to its fund, that it used fund assets to fund advisory operations, and that it caused the fund to overpay \$600,000 in organizational expenses.
- The SEC ordered the adviser and its principals to collectively pay \$140,000 in penalty.



# RECENT SEC ENFORCEMENT ACTIONS

## VALUATION

**SBB Research Group** (Sept. 30, 2019) *Case No. 19-cv-6473*

**Deer Park Road Management Company** (June 4, 2019) *Administrative Proceeding File No. 3-19190*

- In both cases, the SEC alleged that the private fund advisers told investors that fund assets were “fair valued,” but instead used proprietary valuation models and techniques that resulted in the consistent overvaluation of fund assets relative to the results of more traditional valuation methods (in the case of SBB) and observable inputs (i.e., market prices) (in the case of Deer Park).
- With respect to SBB, the SEC is seeking permanent injunctions, civil penalties, and such other relief the court deems proper. The SEC ordered Deer Park and its CIO to pay penalties of \$5 million and \$250,000, respectively.

## CUSTODY

**ED Capital Management** (Sept. 13, 2019) *Administrative Proceeding File No. 3-19448*

**Hudson Housing Capital** (Sept. 25, 2018) *Administrative Proceeding File No. 3-18837*

- Private fund advisers settled claims that they failed to distribute annual audited financial statements timely or at all to investors in their private funds. ED Capital Management (“ECM”) also filed Forms ADV that incorrectly stated the status of its audited financial statements.
- ECM and its principal was ordered to pay a total of \$100,000 in penalty. The SEC noted Hudson Housing Capital’s cooperation and remedial efforts and ordered it to pay \$65,000 in penalty.





# Opportunity Zone Funds



## OPPORTUNITY ZONE FUNDS

- Extraordinary investment opportunity created by the 2017 Tax Cuts and Jobs Act. Still poorly understood. Additional clarity may be provided by final regulations, which are expected to be issued by the end of this year.
- If an investor that has unrealized capital gains realizes those gains and invests them in a qualified Opportunity Zone fund within 180 days after the gains are realized the investor can defer the tax on those gains until December 31, 2026.



## OPPORTUNITY ZONE FUNDS (CONTINUED)

- Increase in basis: if capital gains invested in an Opportunity Zone Fund are held at least 5 years, only 90% of the deferred gain is taxed; if the investment is held at least 7 years, only 85% of the deferred gain is taxed.
- If the investment in the Opportunity Zone Fund is held for at least ten years, the gain on the investment (but not the deferred gain) is not taxable upon election by the taxpayer.



## OPPORTUNITY ZONE FUNDS (CONTINUED)

- There has been increased interest in Opportunity Zone operating businesses (as opposed to real estate development or rehabilitation), which may generate jobs for the communities in which they are situated.
- It was recently reported in the press that some sponsors of Opportunity Zone Funds have been falling short in their fundraising. Some have, but our firm's experience is that many OZ Funds have launched successfully and many others are in the pipeline.



## OPPORTUNITY ZONE FUNDS (CONTINUED)

- Clearly, these funds are not for everyone. But they may present a significant opportunity for the investors for which they are suitable. An investment adviser to an investor with unrealized capital gains may be remiss if it did not take into account the possibility of investing those gains in an OZ fund





## SEC CONCEPT RELEASE

Issued by SEC in June, 2019 to initiate a comprehensive review of the design and scope of the framework of exemptions from registration under the Securities Act of 1933. The goal is to simplify and harmonize the exempt offering framework to promote capital formation while maintaining protections for investors. 211 pages long.



## SEC CONCEPT RELEASE (CONTINUED)

Among the many areas of focus:

- How can the SEC make it easier for smaller issuers to raise capital?
- How can the SEC provide retail investors greater access to the private markets? More capital was raised in 2018 in the private markets than in the public markets.
- Whether the SEC should facilitate secondary trading in privately issued securities?



## SEC CONCEPT RELEASE (CONTINUED)

Among the more interesting proposals:

- Deem an investor to be accredited under Rule 501 of Regulation D if the investor is advised by a registered investment adviser.
- Deem Qualified Purchasers, Qualified Clients and Knowledgeable Employees to be Accredited Investors.
- Permit retail investors to invest in closed-end funds of private funds.
- Shorten six-month safe harbor against integration.



## SEC CONCEPT RELEASE (CONTINUED)

A major question is whether the SEC should revise investor eligibility criteria to focus on investor sophistication rather than wealth. Wealth has served as a helpful proxy for sophistication under Regulation D, but could other criteria serve as better proxies? Why should an investor need to be a millionaire to access the private markets? Some commentators assert that the federal securities laws are fostering wealth inequality. SEC Chair Clayton wants the playing field to be more level.



## SEC CONCEPT RELEASE (CONTINUED)

But would sponsors of private funds welcome retail investors even if the SEC made it possible for them to invest? Many would not, preferring to admit only institutional or high net worth investors. A highly sophisticated investor may be able to watch out for its own interests, but it may not have the financial resources needed to sustain a major investment loss. Such an investor might be more likely to sue a fund sponsor in the event of an investment loss.



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