Private Funds CFO

December 2023/January 2024 • privatefundscfo.com

Joining the club

The rewards, risks and opportunities

INSIDE ESG: A 12-page special report

How CFOs are using data to navigate ESG challenges

Investors share their ESG and impact green flags for GPs

Regulatory shifting sands for ESG and impact

PEI

How to contact us

Editor
Graham Bippart
graham.b@pei.group, +1 212 796 8332

Special Projects Editor
Hannah Roberts
hannah.r@pei.group,
+44 20 4549 1771

Senior Reporter
Jennifer Banzaca
jennifer.b@pei.group,
+1 646 970 3807 ext 190

Washington Correspondent
Bill Myers
jennifer.b@pei.group,
+1 202 908 6191

Reporter
Tom Auchterlonie
tom.a@pei.group,
+1 646 970 3802 ext 165

Contributors: **Claire Coe Smith, Gregg Gethard, Rob Kotecki, Ben Payton, Snehal Shah**

Managing Editor, Production: **Mike Simlett**

Production Manager: **David Sharman**

Senior Production Editors: **Tim Kimber, Adam Koppeser**

Production Editors: **Helen Burch, Nicholas Manderson, Jeff Perlah**

Copy Editors: **Christine DeLuca, Khai Ojehomon**

Art Director: **Mike Scorer**

Head of Design: **Miriam Vysna**

Art Director – Americas: **Allison Brown**

Senior Designers: **Denise Berjak, Lee Southey**

Designers: **Shanzeh Adnan, Ellie Dowsett**

Marketing Solutions Director, Private Equity Group:
Alistair Robinson
alistair.r@pei.group, +44 20 7566 5454

Subscriptions and Reprints
subscriptions@pei.group

Customer Services
customerservices@pei.group

Editorial Director, US: **Rich Melville**

Editorial Director: **Philip Borel**

Director, Product Management: **Amanda Janis**

Director, Research and Analytics: **Dan Gunner**

Operations Director: **Colm Gilmore**

Managing Director, US: **Bill O'Conor**

Managing Director, Asia: **Chris Petersen**

Chief Commercial Officer: **Paul McLean**

Chief Executive Officer: **Tim McLoughlin**

For subscription information visit
privateequityinternational.com

PEI

Private Funds CFO

ISSN 2632-6418 • ISSUE 34 • DECEMBER 2023/JANUARY 2024

Insight

Special report: ESG

Cover story

Analysis

Insight

Subscription credit deal

PNC, Goldman become overnight majors in committed lines

PNC Bank and Goldman Sachs have each acquired part of Signature Bank's subscription lines portfolio, transforming themselves into heavy hitters in the committed lines market overnight, and tying up one of the remaining loose ends from the banking crisis that rocked the fund finance market last spring, *write **Tom Auchterlonie*** and ***Graham Bippart***.

PNC announced that, for its part, the book is made up of $16.6 billion in commitments, adding that the figure includes $9 billion in loans that have been funded.

Goldman purchased about $15 billion in facilities with $9 billion outstanding, *Private Funds CFO* understands.

PNC has been a small player in the subscription credit line business, but this purchase puts them "neatly… in the top 10 or 15 players," one industry banker says.

> "You should expect us to stay active in this space"
>
> Goldman Sachs spokesperson

A spokesperson for Goldman tells *Private Funds CFO* that its purchase was also part of a long-term commitment to the committed lines market. Goldman has been a longtime player in uncommitted lines, which require less regulatory capital since they are not obligated to extend the loans they underwrite, which made its aim with the purchase less clear.

"If Goldman wanted to be in committed lines, they would already be in committed lines," says the industry banker, who suggests that, if the pricing were attractive enough, Goldman may have been enticed into a play to buy-and-hold it until maturities run the book down.

But the spokesperson says "that acquisition is part of a broader strategic plan to increase

our commitment to growing [fixed income, currencies and commodities] financing and serving alternative managers," and adds that "you should expect us to stay active in this space."

Goldman is in the process of pivoting to wealth management, and it has a strong deposit base in its Marcus consumer banking division, which last quarter saw 41 percent revenue growth year-on-year as deposits continue to flood in, potentially representing a strong funding source for committed lines.

Goldman's deal was first reported by *The Wall Street Journal*.

The two banks acquired the loan book from a bridge bank that the FDIC set up when it became receiver following Signature's failure in March. New York Community Bancorp acquired other parts of Signature soon after its demise.

Deal process

The FDIC launched a bidding process for the sub lines book in July, with an October 2 closing date.

At the time, the US regulator said the portfolio had an $18.5 billion unpaid principal balance and was comprised of 201 loans. The FDIC offered Signature's portfolio in four pools that had unpaid principal balances ranging from $4.4 billion-$4.9 billion.

Signature's portfolio appeared to be challenging for the FDIC to sell as it ramped up the process, based on its interactions with borrowers.

Signature was one of three US lenders active in sub lines that failed, were acquired or both.

Silicon Valley Bank failed in March before being acquired by First Citizens Bank out of FDIC receivership, while JPMorgan Chase made a rescue deal for First Republic Bank in May. ■

↑

Private funds managers expect continued growth in their fund sizes, headcounts and firm incomes, despite market and economic headwinds, according to the Private Funds CFO Insights Survey 2024. Seventy-one percent of respondents said their next fund will be larger than the last, and 61 percent expect their firms to grow.

Ups & downs

But fundraising remains extremely challenging. Thirty-nine percent of respondents had to extend the fundraising periods due to the adverse climate. Another 22 percent had to adjust their target fund size (presumably, downward). And 18 percent delayed their next fund launch altogether.

↓

They said it

Wit and wisdom from industry insiders

“It will be really interesting to see what policies we put in place to prevent unauthorized sharing of data with an AI engine”

CFO of a London-based private fund manager speaking at Private Fund CFO Network's Europe Forum in London in November

“We have brought high-quality companies to market and it hasn't really worked”

CFO of a Scandinavian firm speaking at the Europe Forum

“We've definitely communicated to our partners that we're not happy about it. If it's just an effort to try to generate DPI to make that metric look good, in my mind that's artificial”

Investment officer of a large public system on the use of NAV loans to make liquidity distributions to LPs

“The SEC private funds regulations aren't a big deal. They don't really have anything people aren't already doing. It's only lobby groups that care”

New York City-based CFO tells *Private Funds CFO* the SEC's biggest regulatory package is overhyped in its impact on the industry

Sign of the times **Citco streamlines challenging fundraising process**

Citco added a pair of features to its CitcoConnect platform that aims to help sponsors adapt to a tougher fundraising environment by making investor onboarding smoother and allowing GPs to focus more on wooing would-be LPs, ***writes Tom Auchterlonie***.

The first feature enables prospective LPs to carry out online pre-reviews for KYC/AML processes. A second lets potential investors pre-fill their online initial subscription forms with pre-populated information saved.

Bespoke troubleshooting

Citco also says its offering includes features meant to help with consistency and accuracy of LP data for GPs – via tailored questions, question controls and real-time data validations.

The additions to the CitcoConnect platform, which was launched in 2018, come as sponsors face a challenging fundraising environment.

Data from affiliate title *Private Equity International* shows that dollars raised in private equity fell by 12 percent, or $22.9 billion year-on-year during the period from Q1 to Q3, totaling $561.3 billion.

The number of funds closed dropped by more than half during the same period, from approximately 1,800 last year to just 853. And the money raised went to a relatively small proportion of funds, with the top 15 accounting for about 40 percent of the dollars.

> “[GPs can] focus in on the fundraising efforts”
>
> Adam Kapp
> Citco

Slow fundraising climate

The fundraising climate factored into Citco's decision to add the features, Adam Kapp, a senior vice-president with its product development group, tells *Private Funds CFO*.

Kapp explains that the features are meant to make GPs more productive by helping them wrap up onboarding work faster so they can enter fundraising talks sooner with other would-be investors.

"[GPs can] focus in on the fundraising efforts as opposed to the onboarding efforts," he says.

Kapp points out that sponsors can also use CitcoConnect to assess commitment interest among potential LPs.

To do this, GPs can invite prospective investors to Citco's virtual data room housed on the platform – including fund prospectuses and marketing materials – and track which investors view and engage with the materials.

And the service provider is considering further updates to the platform.

Kapp says that Citco is exploring a feature that would enable sponsors to keep up with regulatory changes affecting monitoring of LPs.

"We need to make sure that we are helping our GPs remain compliant."

Citco is also eyeing a feature that would incorporate side letter processes, Kapp says. ■

Fund finance **Investec returns to US**

Investec is officially re-entering the US fund finance market with the hire of Olivia Deroy for origination and relationship management in its fund solutions team, ***writes Graham Bippart.***

Deroy comes from First Republic, which was rescued by JPMorgan amid the US regional banking crisis earlier this year. First Republic's fund finance team has since disbanded, with many showing up at Citizens Bank.

Her hire marks her return to Investec, where she worked for four years in the fund solutions team, which is based in London.

Details on Deroy's exact title, and whether Investec already has hired, or is planning to hire, more people for the team could not be determined by press time.

Investec said the team focuses primarily on private equity but also provides solutions in infrastructure and real estate.

Coming to America

The US team's product focus includes capital call facilities and GP financing to mid-market, closed-end private capital funds.

It will also bring its distribution franchise to the US, according to an announcement.

Investec more or less closed its US fund finance operations in 2020 or early 2021, when Tom Glover departed the bank, later showing up to kickstart a platform at BC Credit Partners.

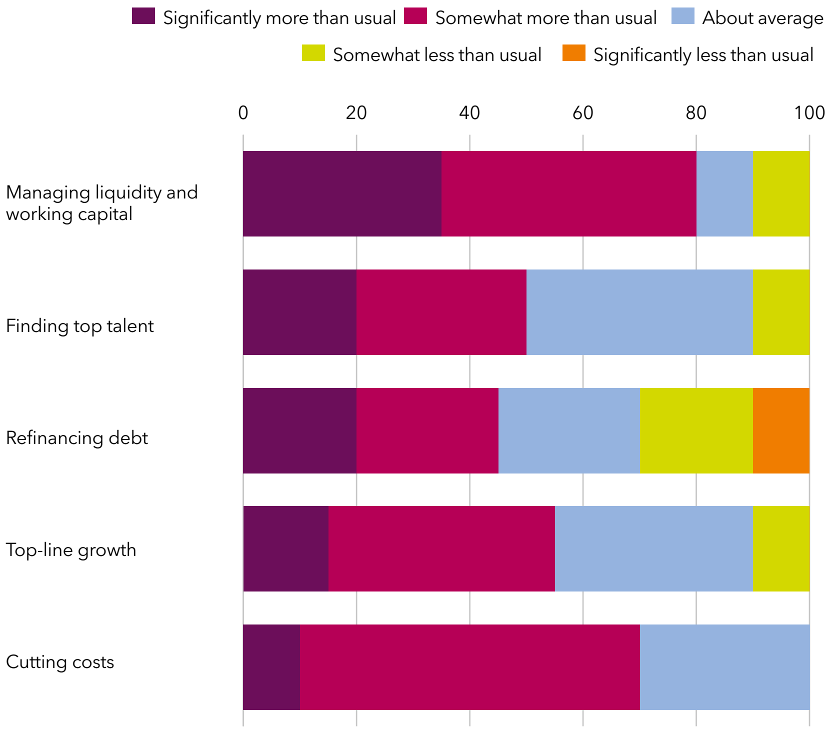
Its return to the US marks the most recent in a spate of banks to open their doors to subscription credit line borrowers. ■

Data snapshot **Firms prioritize managing cash and costs**

Faced with extended hold periods for their portfolio companies, private equity sponsors are focusing on ways to manage working capital more efficiently and cut operational costs, ***writes Jennifer Banzaca***.

While firms are pulling all the value creation stops, today's operating environment has placed high priority on liquidity, working capital and costs initiatives, according to EY's *Private Equity Pulse* report for Q3 2023.

Where are firms particularly focused right now? (%)



Source: EY PE Pulse Q3 2023

Get a grip on cash

Eighty percent of the PE professionals surveyed say they're paying more attention than usual to helping companies get visibility into cash and liquidity needs.

As higher interest rates have varying impacts on companies, those that can generate relatively more cash are more resilient and can deploy that excess cash to fund acquisitions, repay debt, invest in talent or fund business transformation at a time when many of their competitors cannot.

To build the cash discipline and control needed in today's markets, firms and portfolio companies must first "get a firm grip on cash," the EY report says.

"While cashflow forecasts are a requirement for most businesses, they're not always deployed effectively. A short-term direct cashflow forecast built from the bottom up, with a weekly cadence of variance analysis, reforecast and mitigation actions is most effective," the report states.

To manage working capital more effectively, many PE-owned businesses have followed typical cash improvement methods such as extending supplier terms, running down old stock or factoring some of the debtor book, EY says.

Treasury teams can be a significant help in optimizing the liquid nature of the firm's cash position through cash pooling, releasing trapped cash and flexible financing structures; and they can have strong visibility and control of credit covenants and regulations across jurisdictions.

Cost cutting

Cutting costs is another area of focus, with 70 percent of firms saying they are paying more attention to cost takeouts than usual. These firms said it is imperative to take a thoughtful approach that keeps costs under control while keeping growth drivers intact.

EY says in the survey that the ability to identify and execute the right cost optimization strategy can be an all-important differentiator in an adverse market environment. While most companies manage costs for stability, the most successful companies manage for both resilience and future growth.

Firms and portfolio companies need a "true understanding," EY says, of the real cost drivers of the business, whether it has the right competencies and mindset to rapidly deliver on genuine cost savings, and what costs should or could be to effectively serve the customer base and if that cost is sustainable.

Finally, firms must determine the scope, intensity and timing of cost initiatives, followed by a determination of the business areas to be targeted for improvement. ■

Eye of the storm **GPs tackle cybersecurity programmatically**

Sponsors are employing portfolio-wide programs for cybersecurity in part due to rising scrutiny from a myriad of stakeholders, panelists said in mid-October at affiliate title *Private Equity International*'s Operating Partners Forum in New York. These holistic initiatives are necessary due to interest ranging from LPs to prospective customers, ***writes Tom Auchterlonie***.

The event was on background, so speakers' identities can't be revealed. A speaker with a well-known GP said that growing publicity of costly cyber-incidents in recent years spurred businesses to give more consideration to security.

"The people who were not asking those questions started asking those," he said.

Tech drivers

The speaker also cited changes in technology among businesses as a driver, such as the proliferation of cloud-based software and apps.

And failing to make the case that a company has a compelling program can be a competitive disadvantage – even for businesses backed by a mega-sized sponsor.

Another panelist, who heads portfolio cybersecurity for one such GP, said his firm's companies lost out on customer relationships to competitors because their programs were not viewed as favorably.

"Companies are being inspected more thoroughly and if you don't have the security stuff in place to close that deal, there could be business at risk," he said. Stakeholder scrutiny drives the firm's thinking on cybersecurity in a forward-looking way, he said, but internal considerations got the ball rolling.

"Our team recognizes that it's important inside the firm, and that led to natural questions about what are we doing in the portfolio."

One benefit of portfolio-wide initiatives speakers touted is that they foster knowledge and experience sharing across portfolio companies.

> "There could be business at risk"
>
> Anonymous GP

Programs beget connections

A third GP panelist said his firm's program has acted as a way for CIOs at portfolio companies to network, enabling them to ask each other questions about practices. "I think that was part of our secret sauce," he said, noting that networking was considered by the firm when the program was being established.

Information sharing even benefits GPs, which the second panelist noted for his firm's program: "It's turned into a flywheel… as we've learned more from the portfolio, we're able to protect the firm better."

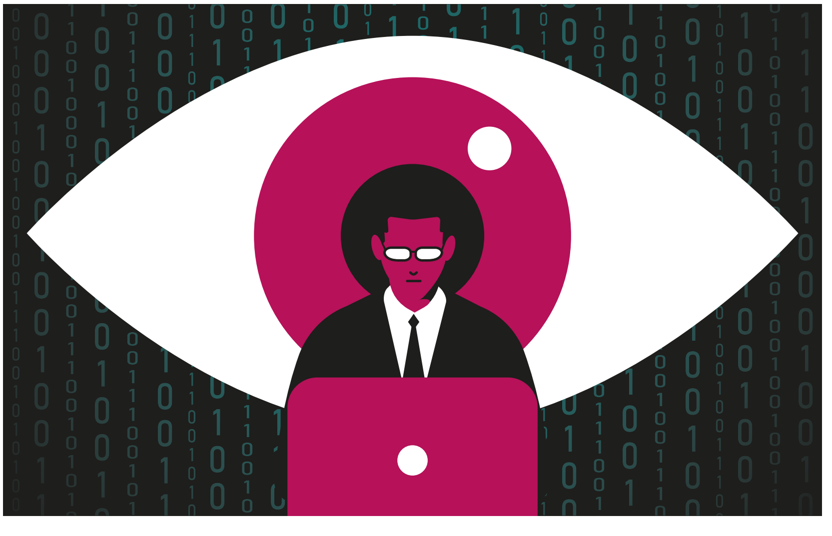
Sponsors' expectations

Panelists also shared how they engage with their companies' cybersecurity executives as part of their programs.

Conducting assessments with portfolio CIOs and creating a post-assessment roadmap that ensures companies make necessary improvements over certain timeframes were among suggestions, as well as ensuring minimum best practices are in place, such as ensuring companies carry cybersecurity insurance.

Firms should also ask portfolio companies about their specific accomplishments in improving their cybersecurity, panelists suggested. They said it is important to keep in mind different portfolio companies have distinct cybersecurity needs, and that firms need to be flexible when implementing portfolio-wide systems.

Even aspects of a system that seemingly represent a "minimum" at one portfolio company may not apply to another, the fourth speaker said: "The minimums may not be a particular company's minimums." ■



Manager's study guide **PF exams to focus on portfolio risk**

American regulators will probe registered private fund managers on how well they are complying with the US Securities and Exchange Commission's marketing rules, how fairly they are disclosing their valuation methodologies and how they are managing portfolio risks, according to commission examiners, ***reports Bill Myers.***

Marketing rule exams will focus on whether fund advisers, "including advisers to private funds," have "adopted and implemented reasonably designed written policies," whether they have "appropriately disclosed their marketing-related information on Form ADV" and whether they have "maintained substantiation of their processes and other required books and records," regulators say in their fiscal 2024 exam priorities, released in mid-October.

On valuations, regulators say they are focused especially on how registered investment advisers handle "illiquid or difficult-to-value assets, such as commercial real-estate or private placements," how well they are protecting "clients' material, non-public information," the "accuracy and completeness" of their regulatory disclosures, firms' policies for vetting and hiring "third-party and affiliated service providers," and whether managers are "obtaining informed consent from clients when advisers implement material changes to their advisory agreements."

"Such reviews will assess, among other things, whether the advisers' policies and procedures are reasonably designed and implemented and whether the procedures prevent the advisers from placing their interests ahead of clients' interests," examiners say. "As with previous years, the division continues to prioritize examinations of advisers that have never been examined, including recently registered advisers, and those that have not been examined for a number of years."

Regulators say they will use fiscal 2024's private fund exams to get closer looks at:

- "The portfolio management risks present when there is exposure to recent market volatility and higher interest rates. This may include private funds experiencing poor performance, significant withdrawals and valuation issues and private funds with more leverage and illiquid assets."
- How well funds adhere "to contractual requirements regarding limited partnership advisory committees or similar structures (eg, advisory boards), including adhering to any contractual notification and consent."
- The "accurate calculation and allocation of private fund fees and expenses," including "valuation of illiquid assets, calculation of post-commitment period management fees, adequacy of disclosures, and potential offsetting of such fees and expenses."
- Due diligence "practices for consistency with policies, procedures, and disclosures, particularly with respect to private equity and venture capital fund assessments of prospective portfolio companies."
- "Conflicts, controls and disclosures regarding private funds managed side-by-side with registered investment companies and use of affiliated service providers."
- Compliance with the SEC's custody rule, "including accurate Form ADV reporting, timely completion of private fund audits by… and the distribution of private fund audited financial statements."
- Policies for the newly expanded Form PF requirements.

'More transparency'

The SEC has been publishing its exam priorities for more than a decade. They are supposed to be a kind of study guide ahead of a firm's final exam. Regulators say they wanted to release their priorities with the start of the fiscal year "to provide more transparency and to continue to move forward together with investors and the industry to promote compliance."

Under SEC chairman Gary Gensler, private funds have gotten the closest looks yet from regulatory microscopes.

There are now more than 5,500 registered private fund managers on the SEC's rolls, and regulators estimate the industry accounts for north of $25 trillion in gross assets. ■

Carry calculations **Cascata lands deal for its waterfall-calculation software**

Cascata Solutions, a provider of software that automates the calculation of waterfall processes, has struck deals with fund administrators ZEDRA and Socium Fund Services to license its software, *Private Funds CFO* has learned, ***writes Tom Auchterlonie***.

The multi-year agreements are part of Cascata's aim to provide faster and more accurate carry calculations.

ZEDRA and Socium will, in turn, gain access to Cascata's software to enhance their own services.

The industry's talent market is still tight, and turnover of staff responsible for waterfall data and calculations – at both managers and their fund administrators – is a persistent threat, but one that Cascata's software is meant to solve, Maarten Robberts, managing director at ZEDRA, says.

"It's solving a real operational problem. It also will make our process more efficient," he adds.

Indeed, CFOs are navigating increasingly complicated means of providing some form of carry to more employees, as pressure mounts to attract and retain talent well outside of the deal team.

To that end, Cascata co-founder Charles Dooley tells *Private Funds CFO* that the provider plans to offer details on GPs' internal allocations of carry to their employees, including their amounts and vesting, by early next year. And he says Cascata is looking to enhance its scenario analysis by the end of 2023.

"Minimally, GPs want a portal where their employees can have direct access and can track their carried interest allocation and valuation," Dooley says.

He also calls Cascata's upcoming feature "a high priority in our product roadmap," adding that its customers are interested in shaping the upcoming feature.

Establishing a standard

Socium co-founder Michael Von Bevern says that Cascata is the third waterfall technology provider that it has worked with since his firm's 2016 founding. Suntera Global, Socium's parent company, this week gave Socium approval to roll out Cascata's software across its global jurisdictions. Von Bevern touted Cascata's product due to its easy set up and user friendliness.

"It [offers a] lot of transparency, including full auditable calculations that allows us to just hand that to the client and say, 'Here, let me know if you disagree with this, either in the way we set it up or the way it's calculating,'" he says.

Manual processes performed largely in Excel are still the industry standard for carry calculation, says Dooley. The inserted data is then exported to accounting software.

Robberts says that ongoing manual data handling between Excel and accounting software invites room for error, as people make copies and start second guessing how formulas should be set up. "Somebody starts to think about formulas and says, 'Well, maybe they should be different.'"

> " It's solving a real operational problem "
>
> Maarten Robberts, ZEDRA

Errors may arise from someone trying to interpret waterfall terms in Excel. Misunderstanding terms can lead to sizable numerical errors, Dooley says. And fund accountants typically use their own calculation methods for various relevant metrics, such as rate of return, and build their own waterfalls.

"There's no standard across the fund administrator's organization," Dooley says.

A third challenge for fund administrators is in handling data from numerous funds, LPs and GPs in Excel. Dooley points to issues arising from American-style waterfalls, where carried interest is calculated on a deal-by-deal basis, greatly increasing complexity.

Automated waterfalls

Clients of Cascata's automated solution will be able to use either open APIs or file utilities to operate

> There's no standard across the fund administrator's organization

Charles Dooley, Cascata

it. The latter is more common, Dooley says.

The file utility serves as "the integration point" between a client's software for accounting and general ledger activity, he explains, naming examples such as Allvue and FIS Investran.

To get data, Cascata works with customers to identify the accounts needed for calculating carried interest, such as capital calls and distributions. Management fees require less work to identify and calculate, requiring only a dashboard on Cascata's end to obtain, Dooley says.

The next step is for a client to use their accounting software to make a standardized query output, which is then uploaded to Cascata's file utility.

Once uploaded, the output is converted and is available in Cascata's system to perform calculations for carried interest, Dooley adds.

There is no Excel file used during any step of this process, he says. But customers can export carry calculations from Cascata as new Excel files, which they can produce for auditing and compliance reasons.

"The waterfall calculations are done literally by a click," Dooley says. This approach gives administrators standardized calculation methodologies, which eliminates the variation risk among fund accountants.

The open API option functions like the file utility one but entails tighter integration between Cascata and customers' accounting software, Dooley explains, as the former's API is "directly mapped" to the latter's API.

Dooley contrasts Cascata's waterfall offering to other solutions, noting that alternatives leave their clients with the responsibility of keeping independent Excel spreadsheets for checking calculations.

And clients can also use Cascata's software to run different scenarios for realizing carry based on the timing of GPs' exits.

Cascata's two fund administration customers are at different adoption points, Dooley says. The goal is to finish ZEDRA's adoption by the end of 2023, while Socium has been working with Cascata since April. ■

Fresh capital

Carlyle keys in on private wealth

Carlyle CEO Harvey Schwartz described the private wealth channel as a "big initiative" for the firm as it aims to grab more investment dollars from high-net-worth individuals, ***writes Gregg Gethard.***

Private equity managers have long relied on institutional investors for their capital-raising needs. But many GP eyes have turned to the wealthiest individual investors to inject fresh capital into fundraising and other opportunities.

Schwartz discussed Carlyle's developing private wealth channel in the firm's third-quarter earnings call held on November 7.

'Big initiative'

"I'm personally spending a fair amount of time in this space," he said. "It's a big initiative for me."

According to Schwartz, private wealth's small percentage of the private fund ecosystem makes it ideal for long-term growth prospects: "As an industry, we have to be thoughtful as capital migrates into this sector."

This year, Carlyle has taken several steps to build out its private wealth strategy. In July, the firm announced the hire of Shane Clifford as head of its private wealth strategy. Clifford previously worked at Franklin Templeton. Carlyle also recently announced a partnership with fintech platforms iCapital and Allfunds that will allow Allfunds clients to access Carlyle's private market investments.

Carlyle reports raising more than $40 billion in the high-net-worth marketplace. ■

After the crisis **Fund managers eye FX diversity**

North American fund managers are overwhelmingly considering diversifying their foreign exchange hedging counterparties in the wake of this year's banking crisis, according to a survey from FX services firm MillTechFX, ***writes Tom Auchterlonie***.

The service provider found that about 81 percent of respondents are looking into diversification after the upheaval that hit regional banks, including Silicon Valley Bank, First Republic, Signature Bank and Credit Suisse. Those banks either failed or were acquired amid the market turmoil.

The survey was taken over the summer and included private funds managers, MillTechFX CEO Eric Huttman tells *Private Funds CFO*. The firm sampled 250 people who serve in senior financial roles.

The banking crisis is hastening attention to FX diversification, Huttman notes.

"I'd say that the issues in the banking sector are a catalyst rather than an underlying cause," he says. "I think it accelerated rather than created the need for it."

81%

Percentage of respondents in MillTechFX survey looking into diversification

He added, anecdotally, that private fund managers are generally more likely than other financial institutions to have only one FX partner.

When your counterparty goes belly-up

The insolvency of an FX partner is a chaotic irony – after all, fund managers look to them to hedge currency risk.

Managers enter into forward contracts with counterparties such as banks in order to protect themselves from FX risks at either their funds' asset levels or share class levels, Huttman explains.

When a bank fails, it may only be able to honor a fraction of the contract, or none at all – leaving funds unhedged.

Figuring out the status of a contract in such an event can be difficult. Managers may be told their contracts are void by the counterparty itself, or be left calculating likely outcomes based on subsequent events.

"This is part of the problem – sometimes the liquidator will communicate that all outstanding trades are being ripped up, other times there is no communication but is the inevitable result of the bankruptcy," Huttman says.

Interest ahead

Managers may also encounter cash problems themselves. Cash posted with the counterparty for margin may be tied up, preventing managers from accessing it.

Huttman says that when a forward's status is uncertain, the entity responsible for a failed bank's affairs, such as the FDIC, can simply determine which contracts are invalid or still in force.

But managers trying to settle their contracts may also not be able to get in touch with the counterparty when they need to, or regulators may freeze the bank from further activity on the market.

There are instances where the entity overseeing a failed counterparty will permit spot trades involving it but not forwards, Huttman explains. This means fund managers can close out their positions via spot trades, regardless of whether the failed bank has been in touch with them about the validity of the hedges, he adds.

Huttman does not believe increasing interest in diversifying counterparties is simply a blip following the spring banking crisis. On the contrary, the CEO anticipates that interest will be "the same or higher" when MillTechFX does the survey again next year. ■

Capital boost **Charlesbank invests in Petra**

Petra Funds Group will receive a majority investment from mid-market GP Charlesbank Capital Partners, ***writes Tom Auchterlonie***.

The firms said that the growth investment will enable Petra to add and retain staff, and to scale myriad offerings such as fund accounting, advisory for fund launches, reporting, compliance and services for management companies.

Terms were not disclosed for the deal, which is slated to be wrapped up during the fourth quarter of this year.

Milestone

The investment marks a significant milestone for Petra. The service provider was founded in 2021 as a lift-out of staff – which is when groups of supporting employees leave for a third-party – from GP Riverstone.

Stephen Coats, Petra founder and managing partner, discussed the practice of lift-outs for a *Private Funds CFO* feature last year on outsourcing.

The firms noted that Petra now provides fund administration, back- and middle-office services to private equity and private credit firms. It is responsible for administering funds and other entities with more than $110 billion in assets.

The service provider has grown through a mix of lift-outs and organic growth, the firms said.

Charlesbank, located in Boston and New York, has $8 billion in assets under management, according to data from affiliate title *Private Equity International*. ■

Digitization for GPs **Ontra rolls out MFN feature**

Ontra is launching a feature that digitizes LPs' most-favored-nation elections, which is being included in its Insight workflow platform for GPs, ***writes Tom Auchterlonie***.

The contract automation provider says its update enables users to turn side letters into digital agreements; create MFN election forms with specific disclosures and provisions; examine elections; and manage obligations.

The new feature is designed to help GPs work with their counsel across the processes.

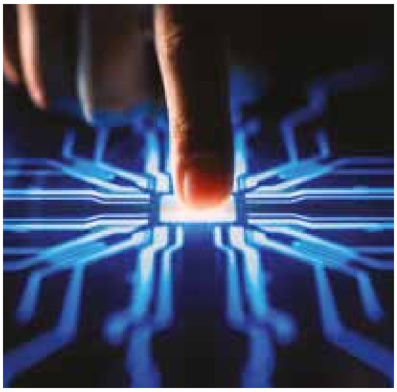
'Quite onerous'

A spokesperson says that parts of the feature are immediately available, while others will be deployed into the first quarter of 2024.

MFN processes for sponsors are "quite onerous," says Nat Kunes, Ontra's chief product officer. He tells *Private Funds CFO* that GPs need to include MFN components in order to get business from large, institutional LPs.

But he notes how complicated this can be, because a sponsor offering favorable terms to a given LP must go back to other LPs with which it granted MFN components and offer them a chance to participate.

GPs also have to track obligations and work with both internal and external counsel, Kunes says. And these steps are costly for funds. "There's a time component to it and it runs up expenses on the fund," he says, noting that keeping costs lower helps with fund returns.



In contrast, Kunes notes that Ontra handles MFN work on behalf of sponsors. "This allows them to automate the entire process."

Software features

Discussing examples, the product chief says the company automatically issues MFN election forms to investors and allows for them to make their elections online. The software also generates workflows tied to MFN obligations, which are assigned to designated people at GPs to complete.

Ontra, which counts Blackstone among its investors, launched Insight in 2020. Kunes says that developing the MFN feature was complicated because it involved making a workflow that is distributed to LPs and is easy to use.

The feature can also help sponsors in complying with the US Securities and Exchange Commission's new private funds rule, Kunes says, citing the portion that requires GPs to disclose preferential fund terms to all LPs in the vehicle. However, he explains that traditional MFN processes remain relevant because the rule does not require GPs to offer all investors participation in those terms.

And the feature can help GPs with their fundraising, Kunes says, as it can speed up fund closures, and that its cost savings can make funds more attractive to would-be investors. ■

Two stages of rescue **US Treasury guidelines for non-banks**

The Biden administration has laid out a two-stage process by which federal regulators may take over a stricken private equity, hedge or other non-bank funds to protect the wider economy, ***writes Bill Myers***.

Officials on the Department of Treasury's Financial Stability Oversight Council voted in early November to approve two guidance documents explaining when and how authorities will designate a non-bank financial institution "systemically important."

Systemic risks

The first is an interpretive guidance document. It lays out the two stages non-bank firms can expect to go through if regulators worry they pose a systemic risk to the economy. The second document says that regulators will analyze a firm's resilience to eight common vulnerabilities – including leverage, "liquidity risk and maturity mismatch," concentration, "operational risks" and others – against the firm's "transmission channels."

Sec 113 of the Dodd-Frank Act says non-bank firms are "systemically important" if their "material financial stress – or the nature, scope, size, scale, concentration, interconnectedness or mix of its activities" – threatens economic stability. Such companies are subject to "consolidated supervision" and "enhanced prudential standards" by the Federal Reserve.

Those laws and rules came after the Great Recession. The Trump administration took a much softer approach to systemic risk, adopting guidelines that required regulators to consider a dizzying array of factors and to conduct a cost-benefit analysis before taking over a wobbly company. The November vote replaces those guidelines.

'Black box'

"Non-bank financial institution" is a broad category that includes insurance companies, currency exchanges and pension plans. Since Dodd-Frank took effect, only four companies have ever been designated "systemically important," all of them insurers. By the numbers, though, the new guidelines threaten investment advisers the most. According to an April analysis by the International Monetary Fund, investment funds (including money market and hedge funds) account for about 15 percent of the world's non-bank assets. Insurance companies and pension funds are the next largest sectors, accounting for 9 percent each, the IMF says.

Private fund advocates fought against the guidelines and condemned them immediately after the vote. They're "flawed," Managed Fund Association president and CEO Bryan Corbett said in an email statement, and "will hurt financial stability." The two-stage "black box designation process," he added, "introduces uncertainty for market participants, harming their ability to deliver for their investors, including pensions, foundations and endowments.

"For the health of the US capital markets," Corbett said, "FSOC should set aside its entity designation focus and continue to work with primary regulators to address risk."

Under Friday's interpretative guidance, regulators will give non-bank firms 60 days' notice before the council votes on whether to move the company into stage two, "an in-depth review of a non-bank financial company using information collected directly from the company."

During that second stage, the council can consider a so-called "proposed determination," which would require a two-thirds vote of the council. The company can then request an administrative hearing before the council to challenge the designation. From there, the process moves to a "final determination." A final determination requires a two-thirds council majority and also a "yes" vote from the council's chair, the new guidelines state. After that, the company's "systemically important" designation will be reviewed every year, the guidelines state. ■

Editor's letter

Managers lean into the SEC's vision of the future

Graham Bippart
graham.b@pei.group

Last year saw a record number of private funds registered with the Securities and Exchange Commission, and the trend looks all but sure to continue as the sector keeps growing. Private credit funds, of course, stand to benefit from normalizing interest rates. And even private equity fund managers expect further growth despite a very challenging fundraising environment and the deleterious impacts of the same rate environment boosting credit.

Nearly 80 percent of respondents to our annual Insights Survey, also published this month, said the tougher macro environment had caused them to either extend their fundraising periods, adjust target size or delay fund launches altogether.

And yet more than 70 percent expect their next fund to be larger, and more than 60 percent expect the next 24 months to bring income and headcount growth to their firms.

> **"Retail investors present a huge opportunity for many smaller and mid-size firms"**

What's behind the discrepancy? Perhaps an overabundance of optimism, or a delay in the acceptance of a new reality. But it also may have something to do with the opportunity GPs see in growing demand from retail, high-net-worth and family office investors.

As Bill Myers reports in this month's cover story, it isn't just when a manager pushes past the $150 million AUM mark that it needs to register with the SEC. It also has to do, in part, with the composition of your investor base. Retail investors present a huge opportunity for many smaller and mid-size firms.

But it also means they have to put themselves under the regulator's purview, right at the moment its demands and scrutiny of the industry are at their most intense.

Graham Bippart

PEI

New York
130 West 42nd Street
Suite 450
New York
NY 10036
T: +1 212 633 1919

London
100 Wood Street
London
EC2V 7AN
T: +44 20 7566 5444

Hong Kong
Room 1501-2, Level 15,
Nexxus Building,
No. 41 Connaught Road, Central,
Hong Kong
T: +852 2153 3240

Private Funds CFO
Published 6 times a year by PEI Group. To find out more about PEI Group visit **pei.group**

Printed by Pureprint Group
pureprint.com

FSC
www.fsc.org
MIX
Paper from responsible sources
FSC® C022913

A chill on DE&I investments

A lawsuit claiming racial discrimination regarding investment programs for underrepresented entrepreneurs could dissuade would-be investors. By Jennifer Banzaca

Conservative activist Edward Blum's racial discrimination lawsuit against venture capital firm Fearless Fund could have a chilling effect on the investment community, speakers at the Culture Shifting Summit, a conference addressing diversity in venture capital and private equity, said recently.

Venture capital and private equity firms could pull back from investing in companies run by underrepresented individuals, and investors could shy away from private funds focusing on such companies, attendees said.

On August 2, Blum's American Alliance for Equal Rights sued Fearless Fund, claiming the fund is operating a "racially discriminatory program" in violation of Section 1981 of the Civil Rights Act of 1866.

Section 1981 states: "All persons within the jurisdiction of the United States shall have the same right in every state and territory to make and enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws and proceedings for the security of persons and property as is enjoyed by white citizens, and shall be subject to like punishment, pains, penalties, taxes, licenses, and exactions of every kind, and to no other."

Blum claims that the Fearless Fund's Strivers Grant Program – which awards small businesses owned by Black

> *"Support looks like dollars... Your actions have to match your words"*
>
> **VC FIRM CEO**

women $20,000 in grants, along with technical support and mentorship – violates Section 1981, because entering the contest essentially forms a contract, and that restricting the prize winners to Black women discriminates on the basis of race.

Landmark cases

In June, Blum's non-profit organization, Students for Fair Admissions, successfully sued the University of North Carolina and Harvard University in two landmark Supreme Court cases that struck down affirmative action on the basis that taking into account racial considerations in the college admissions process violates the Equal Protection Clause of the 14th Amendment.

There has been more focus on diversity, equity and inclusion at investment firms and the companies in which they invest. Investment firms themselves have pledged more diversity in hiring practices and in their investments. But the lawsuit against Fearless could deter LPs from supporting funds with racial mandates, especially in a difficult fundraising environment, and it will be hard for these funds to grow beyond their first or second funds, which many use to replenish sources of capital for entrepreneurs. While investments in businesses and funds owned by underrepresented groups have been seriously lacking, speakers at the Culture Shifting event noted that funds and businesses owned by Black women have the hardest time getting investments.

"The statistics in our work are just awful. Black entrepreneurs have less access to capital and are rejected at three times higher rate than white entrepreneurs when seeking business capital," stated the CIO of a VC firm. The event was held on background so attendees could speak without fear of being identified in the media.

"There's no long line to invest with Black and brown people, or maybe even women. The lawsuit against the Fearless Fund and the repeal of affirmative [action] feels terrifying," added a partner at an early-stage VC firm.

The vice-president at a family office said because of the Fearless Fund lawsuit, allocators who "prize diversity" will have to be more focused on their efforts and also try other solutions to reverse the chilling trend the suit is expected to have.

"There's nothing preventing allocators from continuing to make a commitment to valuing diversity in how we construct our portfolios," she added.

Facing an expected decline in funding to businesses owned by underrepresented individuals, a managing director at a multi-asset manager reiterated her firm's commitment to investing in diverse managers.

"I'm almost sure that we have lost some clients because they think that we're too focused on racial equity. But that won't change how we invest. We're going to keep going. We're going to do as much as we can in this space. We will be creative. We will be innovative. We're not going to stop," she said.

Recently, 70 venture funds – many founded and led by Black female general partners – released an open letter denouncing Blum's arguments that grants and funds dedicated to Black women constitute reverse racism. The letter states that "over $288 billion of venture capital was deployed in 2022, with an estimated 0.41 percent share invested in Black women founders."

According to the letter, Black women received less than 0.35 percent of all VC funding in 2021, while Black founders more broadly receive approximately 1 percent of all VC funding in the US – an estimated $2.25 billion out of the $215.9 billion in venture capital deployed in 2022 figures.

One lawyer speaking at the event said investors need to understand that litigation like the Fearless Fund lawsuit puts DE&I programs "under attack."

"That doesn't mean your programs are not valid. You just have to commit and push forward with your programs to help the historically disadvantaged," he said.

The most impactful way to continue to support underrepresented businesses is through investment.

"Support looks like dollars. It does not look like any type of verbal action, especially at a time like this. If you say you stand for diversity, equity and inclusion, it can't just be rhetorical. Your actions have to match your words," said the CEO of a VC firm. ■

'Flawed from root to branch'

Trade groups and lawyers tee off on the SEC's new private fund rules. By Bill Myers

The SEC's sweeping new private fund rules are "flawed from root to branch" and should be scrapped, lawyers for a handful of trade groups have told federal judges.

"The commission conceded that this rule will cost billions and commandeer millions of hours of employee time, but is unable to cite a shred of evidence that the rule – aimed at 'protecting' the largest, most savvy investors on the planet – is warranted," Gibson, Dunn & Crutcher partner Eugene Scalia and his colleagues say in an opening brief filed on behalf of six trade associations in the Fifth Circuit Court of Appeals in Dallas on November 2.

"Each part of the rule is unnecessary, unworkable, and unduly burdensome – and the commission failed to establish otherwise…

"The gaping holes in the commission's action include a failure to put key last-minute additions to the rule out for public comment, and a failure to offer any serious projection of the rule's likely economic effects. The rule is flawed from root to branch, and this court should set it aside."

A divided commission adopted the new private funds rules in August. Among other things, the new rules require registered private fund managers to obtain fairness opinions on secondaries deals they lead, to distribute quarterly expense reports to investors and to conduct yearly compliance reviews. The rules also require all private funds – registered or not – to disclose side letter terms to their investors and to obtain investors' informed consent before charging exams and investigatory expenses to a fund, charging non-pro-rata fees, opening credit lines or borrowing from a fund's clients or reducing claw backs to offset taxes.

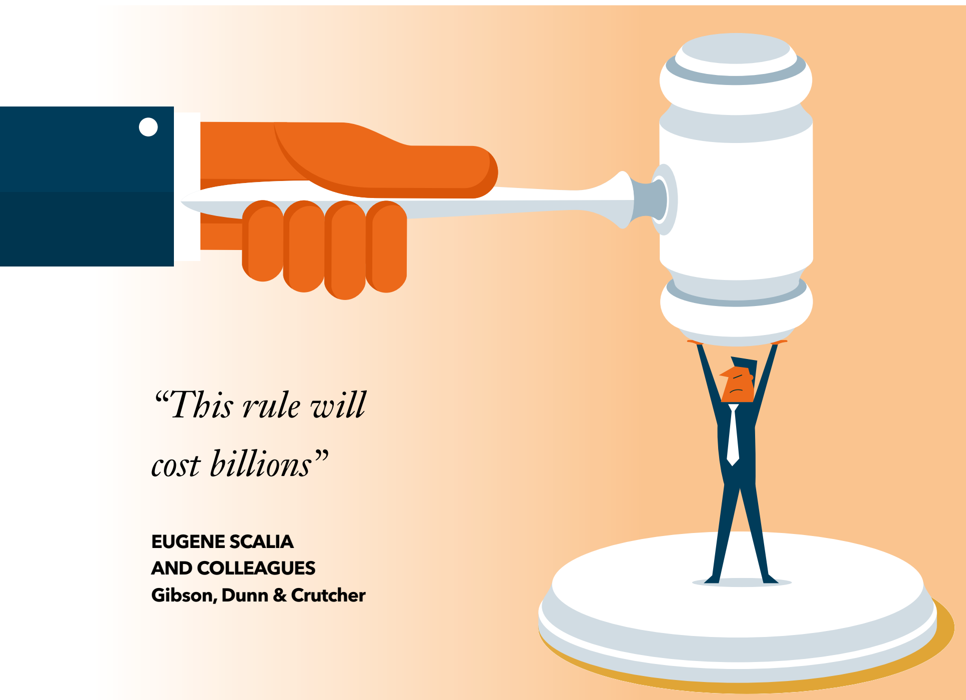
Combined, they represent the most seismic changes to private fund regulation in the US since Dodd-Frank.

Ire focuses on one rule

Industry advocates don't like the new rules broadly, but two elements are especially irksome. The first is the "guidance" language where regulators claim that accelerated monitoring fees and indemnification clauses may well be per se breaches of managers' fiduciary duties. The second – and most important, from the trade groups' point of view – element is the SEC's reliance on rule Sec 211 (h) of the Investment Advisers Act, amended under Dodd-Frank.

That section directs the SEC, "where appropriate," to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the commission deems contrary to the public interest and the protection of investors."

The rule, critics say, gives the SEC unprecedented license to regulate private funds in the future. The trade associations have made clear they are worried that, if courts allow the new rules to stand, the SEC will use Sec 211 for even more onerous and expensive rules. ■



"This rule will cost billions"

EUGENE SCALIA AND COLLEAGUES
Gibson, Dunn & Crutcher

Cross-fund trades: An out for mandatory fairness opinions?

A footnote in the SEC's new rules suggests continuation funds structured as cross-fund trades won't be subject to third-party fairness opinion and valuation letters, writes Adam Le

Buried on page 192 in footnote number 576 of the US Securities and Exchange Commission's 660-page private fund proposals, which were voted through in September, is a small caveat that appears to render one of the regulator's main new rules null and void.

The SEC mandated that continuation fund transactions – a market worth around $38 billion last year, according to estimates by Evercore – are required to have a third-party fairness or valuation opinion in the interest of protecting investors in the selling fund. Such third-party opinions would provide an "important check" against a GP's conflict of interest in such transactions, the regulator said.

The footnote on page 192 states that the SEC would not enforce this rule on cross-fund trades – also known as rollover co-investments – where the GP "does not offer the private fund's investors the choice to sell, convert or exchange their fund interest." In other words, a GP selling an asset from a prior vintage fund into one of its more recent vintages where the original fund's LPs have no ability to "roll over" their fund interest, for example, would be exempt from the mandatory fairness/valuation opinion rule.

Cross-fund trades do not require LPs to elect what to do with their exposure, therefore, structuring a continuation fund as a cross-fund trade – as some secondaries lawyers do on behalf of their clients – would negate the requirement for a third-party opinion and the burdens that come with that, such as added time and fees.

This, despite the fact that in both cross trades and continuation funds, the GP is conflicted as it is acting as both a buyer and a seller.

Recent examples of cross-fund trades include CVC Capital Partners' transaction last year with business services company TMF Group in which it sold a 50 percent stake to Abu Dhabi Investment Authority and reinvested via its long-hold fund, and Bain Capital's sale of its stake in labels and packaging products maker Fedrigoni to BC Partners.

SEC: buried in the small print

Doubling down

In July, affiliate title *PE Hub Europe* reported that IK Partners was in talks to sell its stake in IT and cybersecurity services firm Pr0ph3cy Group and would reinvest alongside acquirer Carlyle and the company's management team.

GPs are even using dedicated so-called "double down" funds to execute cross-fund trades in a systematic way, with TA Associates and Insight Partners having both raised such vehicles. Given their popularity, could more continuation funds now be structured as cross-fund trades, given the protection this footnote appears to provide?

"I do think structuring secondaries as a cross trade provides another option in the secondaries toolkit where a fairness opinion or valuation opinion may not be cost effective or appropriate," says Adam Tope, a partner at DLA Piper who works on fund formation and secondaries.

Cross trades are simpler from a regulatory perspective – plenty of guidance exists on how to cross trade in compliance with the Advisers Act, he notes, adding that funds have been effecting cross trades for a long time and that the SEC has stress-tested such transactions. "It was comforting to see an explicit acknowledgement of this type of structure." ■

Cover story

The paradoxes of SEC registration

More firms than ever are getting registered with the SEC as they grow and look to diversify their investor base – at the same time that the regulator's scrutiny of the market has intensified, writes Bill Myers


Registered with the
SEC

The good news is, a decade and a half of historic growth has pushed record numbers of private equity managers into SEC registration. At the end of last year, nearly 5,500 registered investment advisers were advisers to private funds – almost two out of every five registrants.

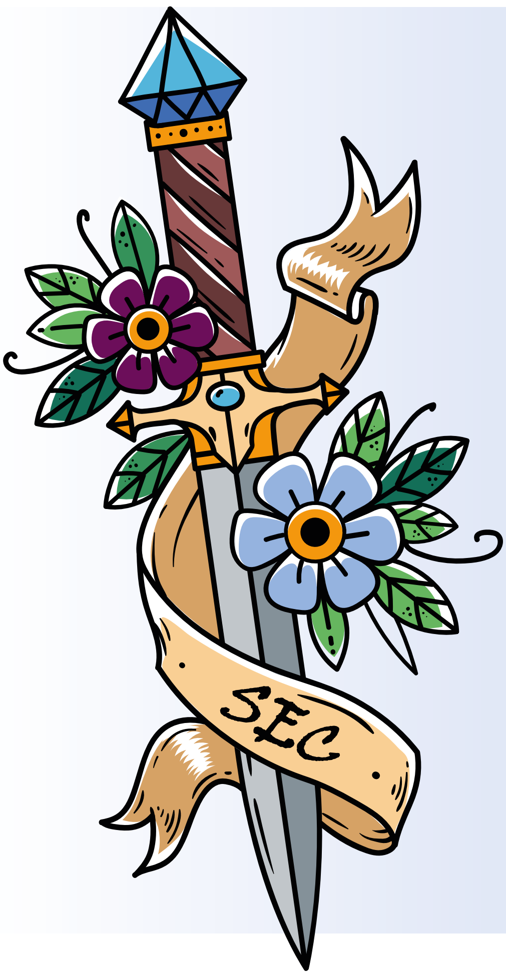
Registered private equity managers accounted for nearly half of the $21-plus trillion in gross assets under management in the sector, according to an annual industry snapshot published by the Investment Adviser Association, a trade group, and National Regulatory Services, a compliance consultant, earlier in 2023.

Under the Dodd-Frank Act, private funds, generally, must register with the SEC if they manage $150 million or more in regulatory assets. (There are some exceptions, including for venture capital or foreign fund managers.) The growth is coming from two directions. One is from smaller managers reaching that Dodd-Frank threshold. The other is from already-registered retail advisers getting into alternative assets. Nearly two-thirds of private fund SEC registrants also advise retail funds, both IAA and NRS analysis found.

But, of course, there's also bad news. Private equity managers are being pushed into the SEC's view just as the regulator has taken the most hostile posture to the asset class since the

"[Registration] has an impact on how you might interact with your existing investors"

NICOLE MACARCHUK
Dechert



SEC cases rise again

The Securities and Exchange Commission filed more than 780 enforcement actions in fiscal 2023, including more than 500 standalone cases netting $5 billion in judgments and orders, commission chairman Gary Gensler said on October 25, writes Bill Myers.

"We use all of the tools in our toolkit to hold bad actors accountable – including bars, penalties, injunctions, undertakings and litigating where appropriate," the chairman told the annual Securities Enforcement Forum in Washington, DC.

"Accountability starts with a robust set of allegations or findings of fact. The public benefits and justice benefits. The allegations and findings of fact convey to market participants – many of them, your clients – what about the action crosses the line. While the press often reports on the monetary remedies, accountability also is about the undertakings or the commitments of firms to update their procedures or retain independent compliance officers."

In fiscal 2022, the SEC brought 760 enforcement actions. That, in turn, was a 9 percent increase over the previous year. As stark as the figures may seem, Gensler said it could be worse for the financial services industry.

"Across numerous actions last fiscal year, the Commission ordered zero or reduced penalties based on the respondents' co-operation," he said. "Keep these actions in mind as you in the audience advise clients on the benefits of self-reporting and co-operation."

> *"The SEC does try to make early contact with newly registered firms, so the compliance policies need to be in place on day one"*
>
> **ADAM ADERTON**
> **Willkie Farr & Gallagher**

Great Recession. Under commission chair Gary Gensler, the SEC has adopted some of the most sweeping changes to private fund regulation since Dodd-Frank itself. More rules are pending.

Even worse: private fund managers are stepping into the harsh regulatory limelight just as the wider economy is wobbling. Overall, SEC registrants – retail and private fund advisers – saw their assets under management decline by more than 11 percent in 2022, the first dip since 2008, IAA and NRS found. Private funds have (slightly) bucked that trend – growing by a little less than 2 percent in assets under management – but that growth has been driven by newly launched private funds. Assets in existing registered private funds fell by more than 7 percent, IAA and NRS found.

The combination of circumstances might be thought of as an industry stress test. Or more optimistically: growing pains. "I tell my clients, 'You've arrived. You're so important now, and so big now that you are of interest to the SEC,'" says Genna Garver, a partner with Troutman, Pepper. "'So, congratulations. Now it's time to get to work.'"

Sticker shock

Registration is a lot of work. The process itself is deceptively simple – it amounts to filling out a few forms with the SEC. But it entails a massive economic and sometimes cultural shift in the way a manager thinks and talks about his or her business.

"It is a quantum leap," says Neel Maitra, a former SEC senior special counsel who is now a partner with Wilson Sonsini Goodrich & Rosati. "You're still subject to the same fiduciary standard, but the quantum leap when you register is the compliance challenge. For the first time, you've got to start keeping policies and procedures around a bunch of other matters. Things such as advertising, pay-to-play, advisory contracts – they all become more onerous. You're going to have compliance burdens around record-keeping and custody. You're still doing the same thing, and are subject to the same broad requirements, but the specifics of what you're required to do go up, exponentially."

Under the Investment Advisers Act, all private fund managers, registered or not, are fiduciaries. They're all subject to the act's antifraud provisions. But registration requires a firm to name a chief compliance officer, who can be held personally liable for their firm's mistakes or wrongdoings. The compliance officer must complete a compliance manual, tailored to the firm's

'More than showing up'

It's not just co-operation, Gensler said. It's "meaningful co-operation." "I'm talking about more than showing up for testimony or producing documents under subpoena. It means going above and beyond to self-report, co-operate and remediate."

Gensler dedicated a fair bit of his speech to condemn crypto, an industry he has repeatedly claimed is rife with fraud.

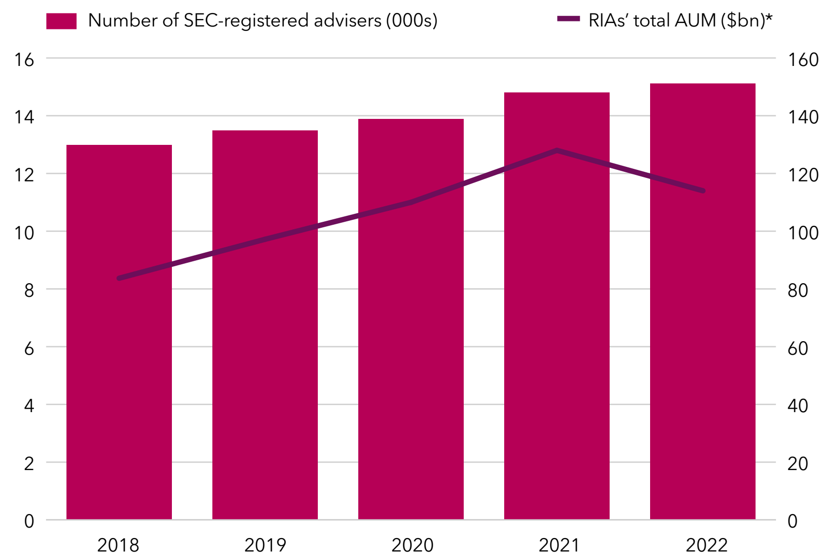
"As I've previously said, without prejudging any one asset, the vast majority of crypto assets likely meet the investment contract test, making them subject to the securities laws," he said. "Further, it follows that most crypto intermediaries – transacting in these crypto asset securities – are subject to the securities laws as well. With wide-ranging non-compliance, frankly, it's not surprising that we've seen many problems in these markets."

Books-and-records violations

Gensler also defended his agency's crackdown on books and records violations. Since December 2021, regulators have brought 40 such cases against firms – 23 of them in fiscal 2023 alone – netting more than $1.5 billion in penalties and obtaining "significant undertakings" from firms, Gensler said.

"Since the 1930s, recordkeeping obligations have been vital to market integrity and the SEC's oversight. At a fundamental level, failures in recordkeeping – like those involving off-channel communications – obstruct such market integrity," the chairman said. "Our actions uncovered not only the widespread use of personal devices and non-official channels to discuss business, but a complete failure of financial firms to maintain or preserve those off-channel communications."

There are a record number of RIAs, even as total AUM fell for the first time



*Discretionary and non-discretionary
Source: Investment Adviser Industry Snapshot 2023

business models, with policies and procedures addressing rules that don't apply to exempt funds, such as the SEC's marketing rule.

"You're going to have to ramp up your compliance spending," Maitra says. "I might have to think about engaging a more sophisticated outside counsel. I will likely have to hire an auditor. All of that is going to significantly bump up expenses. You're going to have to ask whether the two in your two and 20 is going to cover it."

Even before Gensler took the helm, regulators had made clear that it was no longer enough for firms to check a Form ADV box and get on with their day. "We continue to believe," regulators said in their 2021 exam priorities, "it is important to emphasize that compliance programs, CCOs and other compliance staff play critically important roles at firms. Indeed, culture and tone from the top are key."

There were a few "hallmarks" of a good compliance program, regulators said then. "One such hallmark includes compliance's active engagement in most facets of firm operations and early involvement in important business developments, such as product innovation and new services. Another is a knowledgeable and empowered CCO with full responsibility, authority and resources to develop and enforce policies and procedures of the firm," regulators said.

Fund advisers have long been doing more with less. In July, the IAA and compliance consulting firms ACA Group and Yuter Compliance Consulting published the results of their 18th annual investment adviser survey. They found that a majority of firms (nearly half of which advised private funds) spent $500,000 or less per year on compliance.

It's an open question whether, in the Gensler – and post-Gensler – era, that's enough of a spend.

Regular exams

Registration also means firms can expect to be examined regularly.

"A key point is that the SEC does try to make early contact with newly registered firms, so the compliance policies need to be in place on day one," says Adam Aderton, the former co-chief of the SEC enforcement division's asset management group, now a partner with Willkie Farr & Gallagher. "That's probably my biggest takeaway: with registration comes a number of substantive compliance requirements that the SEC is going to examine for, so firms need to be prepared to address them."

For private fund managers who grow into registration, the culture shock can be enormous. Suddenly, the lean, informal style that helped the fund grow may not serve it as a regulated adviser. Under the SEC's books-and-records rules, for instance, all client communications must be tracked, logged and archived. The commission's crackdown on books-and-records scofflaws has landed hard on private funds. And under the marketing rule, an "advertisement" is defined broadly, and its substantiation requirements mean that it's not enough for an advertising claim to be true, it must be defensible. Regulators are already using the marketing rule to crack down on private funds' valuation practices, as well as ESG claims.

Registration also "has an impact on how you might interact with your existing investors," says Nicole Macarchuk, a former general counsel of public markets at KKR who is now a partner with Dechert. An exempt adviser may well be used to picking up the phone to chat with his or her fund LPs, she says. Under the SEC's new private fund rules, which prohibit preferential information rights and require side letter terms to be disclosed, those informal chats may be a lot more complicated, Macarchuk says.

"Now partners are going to have to assess, 'What does this mean? Do I have to report this information to all investors?'" she says. "There's a significant amount of analysis now on what needs to be changed with respect to an adviser's current practices in order to comply with the rules."

Culture shock

Retail advisers who delve into the private funds industry can deal with culture shock, too, says Lindsay Burckett-St Laurent, a senior managing director at compliance consulting firm IQ-EQ.

"If it's a private equity fund and half of their manual is focused on public securities filings – which generally private equity funds don't do – it could be a signal that you haven't thought these policies through," she says. "Whenever I get a new client, the most important questions I have are: who are your clients going to be? Do you manage just private funds? Do you have any retail investors? Is it only separately managed accounts? I want to make sure their compliance program is really tailored to their business."

Tailoring is essential work. Earlier this year, SEC examiners issued a risk alert focused on problems they were finding in newly registered advisers. Regulators had three main concerns. First, fund managers' policies did "not adequately address certain risk areas applicable to the firm, such as portfolio management and fee billing."

Second, they often failed "to enforce stated policies, such as stating the advisers' policy to seek best execution, but not having any procedures to evaluate periodically and systematically the execution quality of the broker-dealers executing their clients' transactions."

Third, the policies were not often "followed by advisory personnel, typically because the personnel were not aware of the policies or procedures or the policies or procedures were not consistent with their businesses or operations."

> *"It's particularly scary for people who are stepping into a CCO role, because it is personal to them"*
>
> **GENNA GARVER**
> **Troutman, Pepper**

As firms approach registration, fund managers should be extra sensitive about the culture shocks it can send, Troutman's Garver says.

"It can be scary for the firms to take on additional liability," she says. "It's particularly scary for people who are stepping into a CCO role, because it is personal to them. It's important to understand that as a firm, your culture is not just the tone you set, but how your people feel."

'Much more of a challenge'

But as demand from retail and high net-worth investors increases, at a time when fundraising is more challenging, some firms see registering as an advantage.

Connetic Ventures is a private equity/venture capital manager based in Covington, Kentucky, with about $40 million in assets under management. It's launching a new retail fund that backers hope will bring ordinary investors into early-stage assets.

"When we started looking at our model, the low-fee model works incredibly well for us," Connetic executive David Ross, who heads up the RIA side of the business, tells *Private Funds CFO*. "We're trying to take the word-of-mouth out of the equation. For us to do that in a private setting is much more of a challenge. If we have this fund that people are interested in, if we have registered investment advisers and broker-dealers selling this, it's going to increase the volume of people we can get."

Funds aren't allowed to tout their SEC registration as a selling point. But registration can be a tacit way of reassuring investors – especially public pension funds – that you're serious about protecting their money. "The SEC says that registration is no Good Housekeeping Seal of Approval, but some investors may insist on it," Willkie's Aderton says. "Registration comes with increased SEC oversight. Some limited partners may take comfort from that oversight and that can help advisers in fundraising."

Costs of not registering

Expensive as registration is, the cost of not registering may be even higher. Registration problems remain one of the leading categories for private fund enforcements in the Dodd-Frank era. In June of 2018, the commission announced 13 separate settlements with private fund managers who were supposed to register but did not. It remains a record for a single-day private fund enforcement sweep.

Under Gensler, the SEC has continued to issue a steady stream of enforcement actions for registration problems. In late September, the commission filed suit against Tarrytown, New York-based consultant Michael Matlin and his firm, Concord Management, which reportedly managed dozens of investments for Russian oligarch Roman Abramovich, who is not named explicitly in the suit. The SEC is accusing Concord of failing to register in order to hide assets for the unnamed oligarch, known as "Ultimate Beneficial Owner A" in the 25-page complaint.

Troutman's Garver says there's another way to read that suit, too.

"This case, as alleged, is really about operating an unregistered business that cannot be a family office and is not prohibited from SEC registration on the basis that their activities rose to the level of regulatory assets under management," Garver says.

It's possible to read against the commission's complaint, Garver says, to see the tasks regulators claim Matlin and Concord were conducting – everything from portfolio management to negotiating side letter terms – to get an idea of what regulators view to be continuous and regular supervisory or management services for purposes of calculating regulatory assets under management; ie, an investment adviser who should be registered with the commission.

"They break down the individual tasks that they were allegedly performing in pretty solid detail, and I don't believe I've seen anything similar to this," she says.

Outsourcing relief

The good news is, private fund managers don't have to brave the new world of registration alone. A small army of compliance consultants has mobilized to help firms get a handle on their new responsibilities. In 2022, nearly 7 percent of all registered advisers outsourced their compliance functions completely, according to the IAA and NRS industry snapshot. That's nearly a percentage point higher from the year before.

"If you manage tens of billions of dollars, that's potentially a more cost-effective way to go," Connetic's Ross says. "There are service providers that are very good at these services and do it at a very attractive rate."

Some firms are so bullish about regulatory compliance outsourcing that

> *"If we have registered investment advisers and broker-dealers selling this, it's going to increase the volume of people we can get"*
>
> **DAVID ROSS**
> **Connetic**

The 'three Es'

The day before Gary Gensler's annual Securities Enforcement Forum in Washington, DC, SEC Enforcement Division chief Gurbir Grewal told a separate audience of compliance officers that "a culture of proactive compliance" comes down to "three things: education, engagement and execution."

"First, it requires you to educate yourselves about the law and external developments relevant to your business, particularly emerging and heightened risk areas," suggested Gensler.

When the commission recommends a new enforcement action, it puts a lot of thought into making sure that charging documents, whether settled or litigated, clearly telegraph the basis of the misconduct to industry participants, noted Grewal.

Engagement, Grewal said, "requires you to really engage with personnel inside your company's different business units and to learn about their activities, strategies, risks, financial incentives, counterparties, and sources of revenues and profits.

"You may come across aspects of your firm's business that you do not completely understand. That's not an excuse to punt. Take whatever steps are necessary to learn and understand the issues. Those of you who work in the compliance function are leaders inside your organization and through proactive internal engagement you will be better prepared to discharge your duties. This understanding is critical to designing and adopting meaningful policies and procedures."

Execution also means it's no longer enough to have well-written policies, Grewal said. Firms must enforce them, too.

"Time and again, we see firms that have good policies, but fall short on implementation," he said. "Our ongoing off-channel communications sweep to ensure that regulated entities, including broker-dealers and investment advisers, comply with their recordkeeping requirements is a good example."

they're investing in it as a business line. In July 2021, for instance, Montagu Private Equity announced it had taken "a significant" stake in third-party compliance firm Waystone. The firm set growth targets north of 30 percent. Grandview, a research firm, estimated that the regulatory outsourcing market had reached $6.8 billion by 2021. It's expected to grow nearly 12 percent per year through 2028, Grandview noted.

Outsourcing carries its own risks, of course. Regulators have made it clear that private funds can outsource a function, but they can never outsource their fiduciary duty. In its March risk alert for newly registered advisers, the SEC warned funds about buying "off-the-shelf" compliance manuals that didn't have a lot to do with the funds' actual business. The commission is weighing new rules that would require funds to vet its outsourcing firms thoroughly, and to re-vet them at least annually, for things like conflicts of interest or material, nonpublic information. Even before the SEC put those proposed rules out for comment, it opened an exam sweep asking private funds about their third-party due diligence.

"There are ways in which you can structure your outsourcing and meet your fiduciary duty, but you've got to do your due diligence and provide sufficient oversight over their activities," Dechert's Macarchuk says.

Be prepared

The SEC itself can also be a form of help, albeit an indirect one. The agency's examiners have issued dozens of risk alerts and have published their priorities every year. Experts say compliance teams should read them carefully to understand what regulators are worried about, and why. Since 2020, in fact, the commission has issued two risk alerts aimed solely at private funds. One came in 2020, the other in 2022. Combined, the two alerts stress several themes that private equity managers ought to be aware of, including fees and expenses, conflicts of interest, protecting material non-public information from leaking out, valuations, advertising claims, books-and-records rules and vendor due diligence.

"You can reasonably expect that within the first couple of years after you register, the SEC exams staff is going to make contact with you," Willkie's Aderton says. "You should be preparing for that contact so you can establish that you're in compliance with all the rules that come with registration."

The $150 million Dodd-Frank asset threshold is the most obvious mark that tells your firm it's going to need a bigger compliance boat. But there are others.

"Obviously, there's a money threshold there," Maitra of Wilson, Sonsini says. "There's a red, blinking signal as you get closer to that $150 million threshold. The other is your client base. Are they getting more sophisticated? Even amongst that mix, if you start seeing for example that you've got registered investment companies in there, if you've got other hedge or private equity funds in there, some of the larger family offices, you've got to start thinking about registration. The registration burden doesn't start with filing, it starts with deciding to register." ■

SPECIAL REPORT
ESG

Why CFOs need strength in numbers

Hannah Roberts
hannah.r@pei.group

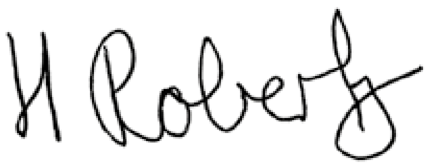
What seemed like an entirely rational move toward private markets firms adopting better environmental, social and governance practices seems to have hit a roadblock – at least in the US, where some states have launched a backlash against ESG-motivated investment.

But while such developments are being watched closely across the industry, many CFOs' approach toward ESG has moved beyond that of implementation and toward effective data management.

Indeed, having the statistics to back up ESG credentials is becoming an increasingly important tool in the modern CFO's kit – regardless of what individuals may think of the current political situation. According to *Private Funds CFO*'s *Private Fund Leaders Survey 2023*, 69 percent of fund leaders say that increasing demand from investors is driving adoption of greater ESG monitoring and reporting in their firms – and when LPs speak, GPs listen.

"Without having effective ESG data to hand, CFOs are left exposed to a number of risks"

Without having effective ESG data to hand, CFOs are left exposed to a number of risks. Maintaining a proactive approach to regulatory developments on responsible investing, ensuring that value creation plans are based on usable, up-to-date information and meeting internal social responsibility goals: all of this falls into the lap of the modern CFO. By boosting their ranks with both internal and external expertise, and in spite of the relative fluidity of the current situation, it seems CFOs are taking a longer-term – some might say sustainable – approach to ESG.



Hannah Roberts

Contents

How CFOs are using data to navigate ESG challenges

Private markets have accepted that ESG isn't a fad, but as backlash against such initiatives persists, effective data management may provide a solution. Rob Kotecki reports

Despite its assumed entrenchment within the private markets, environmental, social and corporate governance issues are frequent figures in newspaper headlines – and not for wholly positive reasons. In the US, progressives dismiss ESG-focused investment programs as 'greenwashing,' arguing that they only provide PR cover for the same old bad behavior, while conservatives believe them to be part of the liberal 'woke' agenda that will sink the economy by eschewing profits in favor of expensive, feel-good initiatives.

In contrast, Europe is doubling down on its commitment to ESG priorities, with several efforts underway to ensure those three letters live up to their best intentions.

But private fund CFOs don't have the luxury of pundits or activists to simply rail against the trend even if they wanted to, instead needing to find ways to make ESG work for the firm and its stakeholders. Larger, established firms can afford to bring ESG expertise in-house, but for those that can't, ESG lands in the CFO's lap.

As such, CFOs have largely accepted that ESG needs to be more than language that gathers dust in the back of a PPM. And investors have become increasingly vocal about ESG risks, requesting massive amounts of data around ESG metrics. CFOs have responded by doing their best to tailor their programs to the unique needs of their investment strategy.

However, the common thread among CFOs is that, for now, the ESG challenge is predominantly one of data management. Tracking ESG requires a second portfolio of data that needs to be collected, vetted and reported, with the caveat that there's no standardized methodology, which raises concerns about how best to measure behaviors that affect multiple departments in the same portfolio company.

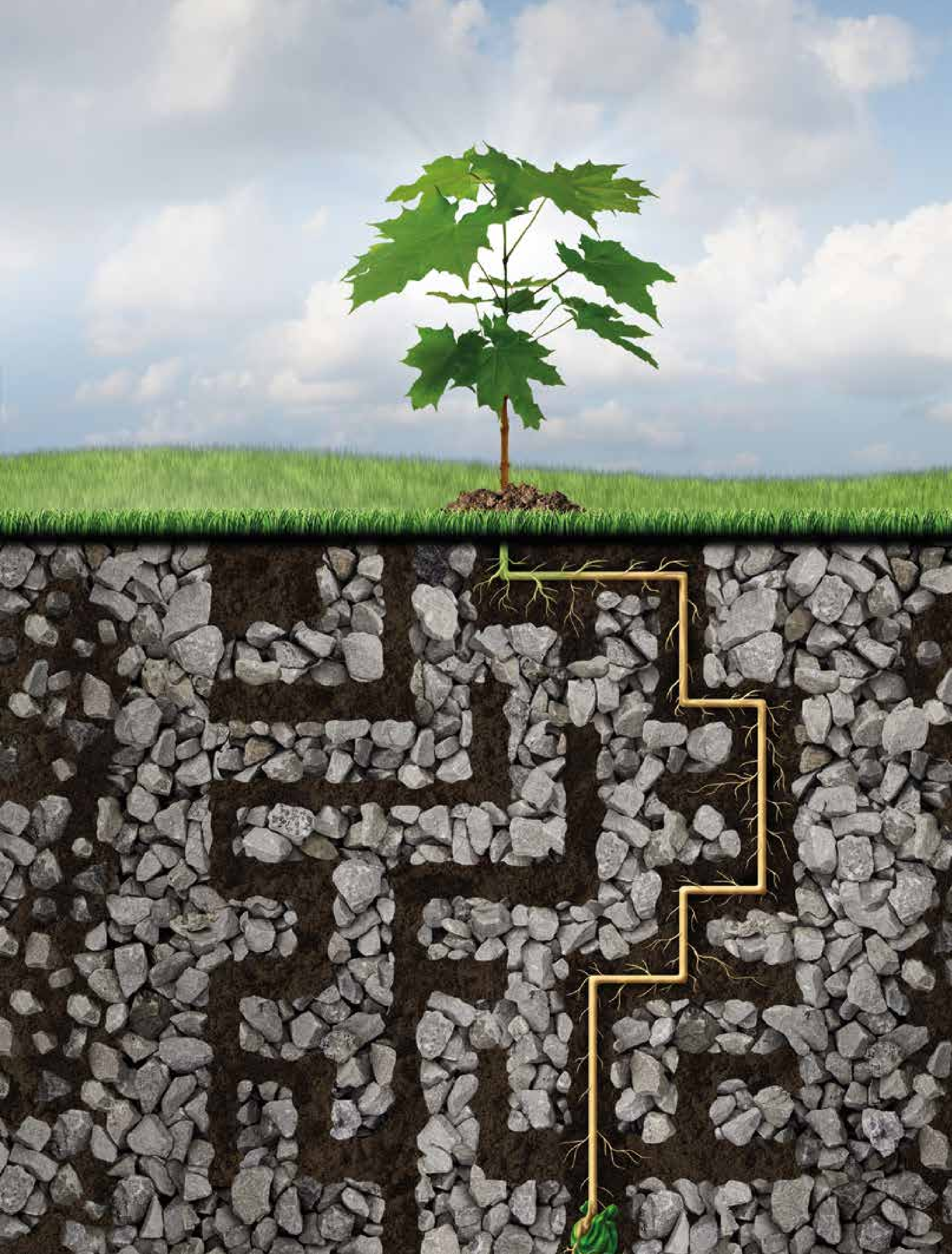
The best answer that many have right now is to focus on tapping expertise, either by hiring more staff or bringing in external consultants, getting leadership to buy into the process and remembering that any incumbent ESG program will continue to evolve for years to come.

Walking the walk

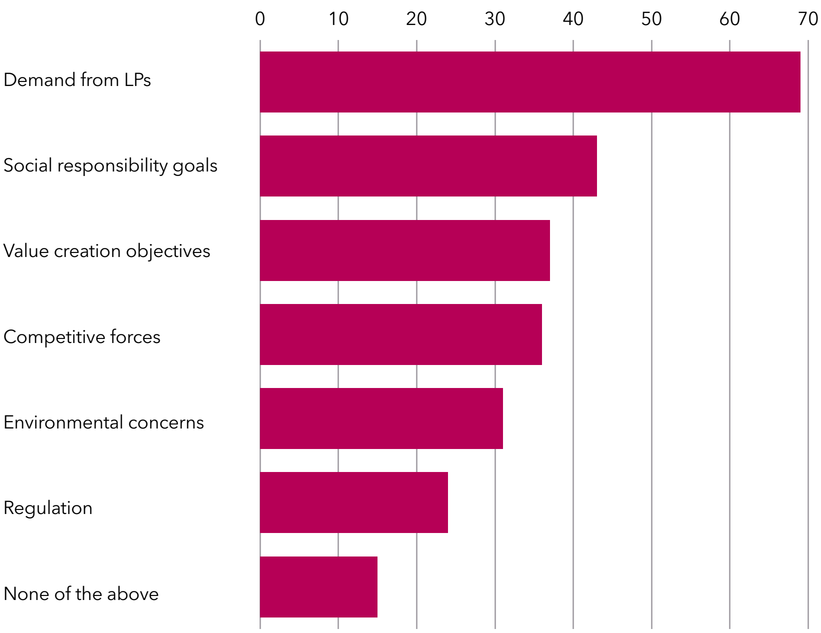
Right now, CFOs are taking ESG issues seriously. "We always paid attention to these issues, but we've crossed that Rubicon and recognized that ESG is here to stay," says April Evans, CFO at Pace Healthcare Capital. "An increasing number of LPs are very interested in using their investment dollars to speak specifically to ESG issues."

This doesn't mean that investors are all turning into environmental activists. "LPs want to understand their exposure [to ESG risks] along a certain series of metrics," says Melissa Dickerson, CFO at Genstar Capital. The consensus is that while there are investors looking to drive toward audacious goals like net-zero emissions in the next few decades, some just want GPs to take a proactive approach to mitigating risks.

In a 2022 survey by Intertrust Group, 96 percent of CFOs said that ESG is important to their LPs. In the



Which factors are driving adoption of greater ESG monitoring and reporting in your firm? (Multiple answers allowed; %)



Source: Private Funds CFO Private Fund Leaders Survey 2023

same report, CFOs said that 77 percent of LPs want live or daily updates on portfolio performance, and 56 percent expected the same on ESG matters.

Meanwhile, 69 percent of respondents to *Private Funds CFO*'s *Private Funds Leaders Survey 2023* reported that increasing demand from LPs is driving adoption of greater ESG monitoring and reporting in their firms.

The data dilemma

Many CFOs agree that amid the wider ESG push, one key part of any such initiatives will always end up on their desk: data management. "ESG professionals don't tend to be data gatherers," says Dwight Cupit, CFO of Bregal Investments. "But that's what the finance function does. We have the systems and the processes to collect data, so we'll do that, and pass it along to our ESG staff for interpretation."

But gathering effective data on this topic is not a simple task. Cupit recently invested in a separate tech system to gather and export ESG data from portfolio companies. "We had a portfolio monitoring system that might have been able to do some of the work, but after collaborating with our ESG team in a long process, we decided it was worth investing in a separate solution."

The dilemma isn't merely managing massive data sets, but also the lack of a common methodology, and sometimes even a sense of the best metrics to use. "CO2 is easy to track because it's something that can measured, but what about data that's spread across multiple functions?" asks Dickerson. "Some of them require gathering data from HR, operations and finance, and unlike accounting practices that have developed over years and years, this is all new."

Thomas Braun, CFO of Germany-based investment firm Golding Capital Partners, says having a common methodology is crucial to success, "because if every single player is developing their own ESG toolkit, it won't work… Investors might be grateful for the data, but then face the burden of reconciling all those separate [Microsoft] Excel spreadsheets into their own report. We're only going to get ahead of the curve around sustainability if we have a European, or even better, a global toolkit for managing this data." In lieu of that, how are CFOs tackling all the work?

Addressing such demands often involves hiring in-house ESG experts, but not everyone has the capacity to do so. "To a shop, everyone I know has an ESG policy in place," says Pace Healthcare Capital's Evans. "The larger shops have ESG officers, but for smaller firms, it falls to the CFO to not just craft the policy, but then also manage its implementation, to ensure we're doing what our policies say we're doing."

Half of the respondents to the *Private Funds Leaders Survey* have an internal ESG team, but 40 percent

outsource some part of their program. Those with the means to hire internal staff are big proponents of it, but CFOs agree that specific expertise is a necessity, no matter how it's contracted.

"We outsource, because we want to partner with folks with real domain expertise, in the way we would tap SEC-trained attorneys to tackle regulatory matters," says Genstar's Dickerson.

The lack of common methodology only ups the need for expertise. "There are multiple different paradigms out there from the [Organisation for Economic Co-operation and Development] to the EU's [Sustainable Finance Disclosure Regulation], and our ESG consultant is invaluable in sorting through them all," adds Dickerson. But for CFOs with the resources, they're fans of their internal ESG staff.

"We've been lucky to have built a large, dedicated, ESG team, which makes it so much easier for me," says Cupit. Even for CFOs that get lucky, there's still plenty to do.

"We work very closely with our director of ESG and director of impact, but processing ESG data and preparing the reports is part of the CFO unit," says Braun.

And hiring ESG staff comes with the added bonus of demonstrating the firm's commitment to the process, which helps win over skeptics.

96%
Proportion of CFOs who say that ESG is important to their LPs

Source: Intertrust Group, 'The future private capital CFO: Unleashing potential in the ESG era' 2022

56%
Proportion of LPs who expect live or daily updates on ESG matters

Source: Intertrust Group, 'The future private capital CFO: Unleashing potential in the ESG era' 2022

69%
Proportion of fund leaders who say increasing demand from LPs is driving adoption of greater ESG monitoring and reporting in their firms

Source: Private Funds CFO Private Funds Leaders Survey 2023

"For private equity firms, ESG has to start with the leadership," says Cupit. "When we hired an ESG team, that showed our commitment to this process."

Private equity firms are not immune to the lingering skepticism around ESG. "So many of my peers have, like me, been pleasantly surprised by our leadership's willingness to get on board with ESG priorities once we lay out the benefits logically," says Evans. "But there are those that still resist this idea of looking beyond whether an investment will simply make money, without realizing that considering other factors can improve returns as well."

"I think the biggest single change we've made to our ESG program is that it's been elevated on our investment committee, so every investment memo now has an ESG section," says Cupit. "Now if someone doesn't address ESG issues in the investment memo, it's not getting to the investment committee, so the deal team learns quickly to get that included."

An evolving discipline

However, CFOs are aware that no ESG integration may ever be 'complete.' "ESG programs are living, breathing things," says Evans. "We may learn down the road that one component or metric, that made sense five years ago, doesn't make sense anymore. So, we revise it and might tighten some processes or find a way to be more granular around a particular issue."

Braun adds: "The solution to the status quo is to focus on collecting and evaluating data, with the idea that there will be constant reassessment in the coming years.

"Do we see a positive development? Is this transition pathway credible? So, each year builds on the last one to get more effective."

In doing so, a firm's ESG program becomes, in itself, sustainable – and clearly no one expects sustainability issues to move out of the spotlight anytime soon. ■

KEYNOTE INTERVIEW

Moving ESG into the fast lane

Managers need better data management and analytics to capitalize on ESG opportunities, says Andrew Pemberton of BasisPoint+

There is little doubt that a credible environmental, social and corporate governance strategy is fast becoming a 'must-have' for fund managers. Andrew Pemberton, chief executive officer of ESG and impact investing software and services provider BasisPoint+, says firms need effective systems for responding to increasing ESG data demands from LPs and regulators. Looking beyond the back office, Pemberton believes that attention to material ESG considerations can help managers push beyond compliance and risk management to drive new value across their investments and broaden their investor base.

SPONSOR
BASISPOINT+

Q What does the growth of the ESG and impact investing market mean for managers and their data needs?

All signs point to ESG and impact investing being a force that is here to stay. A 2022 study from Bain & Company and the Institutional Limited Partners Association found that 70 percent of LPs consider ESG in their asset allocation decisions, and the US Securities and Exchange Commission updated its guidance in September to include ESG investing in its Names Rule. But expectations for how exactly managers should integrate ESG and what they must disclose will continue to evolve.

As a result, more effective ESG data management will be critical within the private funds industry to meet these requirements and to see their benefits. Managers will need a data strategy to help them be proactive in responding to LPs today, while maintaining the flexibility to adapt to a changing regulatory environment. The key for GPs will be to manage both of those dynamics in a way that is relevant to their strategy and effective in creating value within their firm and portfolio.

That means integrating deeper with risk-return analysis to drill down on which ESG levers can help optimize business performance. It also means more thoughtful engagement as part of post-investment value creation plans.

This way, managers can prioritize efforts that are most valuable to them and get ahead of the reporting burden to add to their bottom line.

Q How big a challenge do managers face in making sense of and staying current with regulatory standards and LP requirements?

It is a bigger challenge for some managers than for others. For managers that have already spent years integrating ESG or impact into their strategy, simply making systems updates can improve efficiency and extract more useful insights. For most managers, though, it is a big lift to get a well-informed approach off the ground and it requires ongoing attention toward understanding the space once they are up and running.

There are three main factors that, as I see it, hold managers back from building an effective strategy for ESG integration. The first is at a strategic level. It takes time and effort to understand the landscape of ESG standards and their application to a given firm. Just knowing where to get started can be a big challenge in itself, especially when it is so critical to distill ESG theory down to practical, context-specific frameworks and processes.

The second factor is operational. Most managers lack clarity on where in the organization ESG expertise should sit and what resources will be needed to run a decision-useful process. It is important to understand the desired end goal and then find the right balance between empowering internal teams and engaging external partners.

The third blocker is related to return. ESG integration is itself an investment and managers are eager to see how these efforts translate to profit and cost optimization. Once a right-sized ESG strategy is determined, returns follow by applying it in due diligence and portfolio engagement – with a strong data management system – to drive business insights.

"ESG integration is itself an investment and managers are eager to see how these efforts translate to profit and cost optimization"

Q What steps can managers take to start putting an ESG strategy in place?

At BasisPoint+, we typically recommend a four-point plan to get started: designate a point person, determine scope of relevant ESG considerations, define the analytical methodology and delegate responsibilities.

Managers need to start with an internal champion to set the agenda and work toward internal alignment, since ESG implementation spans teams and functions. That person can help carry out an initial analysis to determine which ESG factors are most relevant to the sectors in which the GP invests. After that it comes down to refining the methodology and determining where execution responsibility lies across teams. By starting from a clear set of objectives and agreeing on a common language, managers can be sure to comply with relevant standards and avoid any accusations of greenwashing.

Q What kind of external support do managers typically need?

It depends on the gaps that exist within their firm. There are expert service providers that offer strategic planning guidance; deal team, compliance or investor relations support; or dataset access and collation for more complex analyses.

With regard to technology, there is growing recognition that process automation and business intelligence tools are imperative to make sure relevant data – ESG, financial and contextual – is accurate and useful in practice.

That's our focus at BasisPoint+. Our offering is purpose-built to meet leading standards for both investment process and reporting best practices. The templates, workflows and dashboards are easy to navigate and customize. Managers can use our platform entirely on their own, or they can rely on our industry experts to guide them through strategy set-up, due diligence, value creation and report generation.

We go a step further, too, with capital advisory services that can help managers use their ESG or impact strategy to engage new LPs and identify aligned investment opportunities across our ecosystem.

Q It takes sustained effort to build solid ESG credentials – will the returns be worth it?

The short answer is yes; there is a strong body of research validating ESG as a useful investment lens to accelerate revenue growth, increase profit margins and improve fund returns.

By design, ESG integration accrues benefits over the medium- and long-term. In the near-term, managers should look at time saved in research, compliance and reporting functions as a key indicator. They should also consider the benefits of positioning their strategy to maximize their appeal to target LPs and investment prospects: a credible ESG approach can help open doors and demonstrate management alignment in a new way.

It is important to remember that an ESG strategy is not designed or executed in a day. At this stage the goal is progress, not perfection. Managers should feel at ease knowing that there is significant value in getting started and having a baseline from which to learn and iterate – and that our team at BasisPoint+ is here to help along the way. ■

Investors share their ESG and impact green flags for GPs

Data convergence participation, sustainability skills and portfolio-level value creation plans were top of mind for asset owners and investment consultants at PEI's Responsible Investment Forum in San Francisco in September. By Snehal Shah

Portfolio details

"We are increasingly seeing our LPs wanting more transparency and insight into what's going on in the portfolio in terms of ESG," said one investment consultant.

"I get calls all the time [from LP clients] asking, 'Can I have a comprehensive ESG report on my mature private equity portfolio?'" said another consultant. "That's about 80 funds, a few thousand portfolio companies."

"One of the real value-adds is when you have a dedicated function that can go in and be an operating tool for a portfolio company," said another LP.

They added that a GP's ESG professional should be "working with the CEO or CFO to make sure the messaging is coming down from the top that these ESG KPIs are important for our company… [and] doing the day-by-day work of working with the operations, HR [and] the portco's sustainability team."

Another LP, investing from a dedicated climate investment bucket, said: "Every investment has a hundred-day plan rolling out financially material sustainability factors.

"It's several points in the deck. It's something that we hold [our GPs] accountable to; it's something that they hold their [portfolio company] management teams accountable to."

Investors want to see detailed information on environmental, social and corporate governance issues from their fund managers – including industry standard KPI data, value creation plans and direct involvement with portfolio companies.

Investors present at PEI Group's Responsible Investment Forum in San Francisco, held in September, shared the sustainability qualities they find most attractive in fund managers. The conference was held under the Chatham House Rule, meaning that comments could not be attributed to speakers.

Firm commitment to ESG

Dedicated ESG professionals are a positive sign for LPs.

"It's really exciting and really encouraging to see that [firms] are starting to take action and put real dollars to work to build a bench of [ESG] talent," said one LP. "There are a lot of [investment professionals] that are getting retooled and reskilled today to have that skill set, and there's a lot of outsourced talent."

There should also be buy-in across the firm – beyond the ESG department – on sustainability issues, several LPs noted. One investment consultant said it asks GPs "how [their] investment teams, board members [and] operating partners are starting to think about sustainability considerations as a driver of value."

EDCI participation

Many asset owners and investment consultants expressed support for the ESG Data Convergence Initiative.

"It resolves some of the complexities" of different ESG data requests from investors and comparing ESG data across portfolios, said one consultant.

"One of the ways we're looking at using the ESG data is to supplement our estimated greenhouse gas emissions data for our LPs with the information that we'll have access to through our GPs that are signed up to EDCI… that's really important to some of our LPs," said the consultant.

Standardization initiatives such as the EDCI have been criticized for neglecting materiality – the ESG factors uniquely relevant to different assets.

As well as providing data for the EDCI's six focus areas, "GPs need to continue to understand and look at their portfolio companies to think about which ESG factors are financially material to their portfolio companies, and not just what the industry standards have become," said another consultant.

Regulatory shifting sands

A consultation on SFDR has raised questions about what the regulatory framework for impact and ESG strategies will look like in Europe, writes Claire Coe Smith

In September, the European Commission injected some uncertainty into the future regulatory environment for environmental, social and corporate governance issues and impact investing when it issued a public consultation on the EU Sustainable Finance Disclosure Regulation (SFDR). By revisiting the use of the Article 8 and Article 9 categories that impact funds currently fall into, the review could potentially lead to significant changes for the industry.

One problem with SFDR is around its use as a labeling regime, says Patricia Volhard, a partner at Debevoise & Plimpton: "While SFDR is meant to be purely a disclosure regime, for Article 9 funds it really isn't because all of your investments need to meet certain standards to qualify for that classification. Investments need to make a substantial contribution to environmental or social objectives and at the same time should not do significant harm to any other ESG factors. But that raises questions about how you define a substantial contribution and also how you determine what is significant harm, so it doesn't really work as a label as it stands."

The commission's intention was not for SFDR to serve as "a label of quality or quantity," adds Volhard. "The idea was to force people to be transparent in terms of what they are doing and to use consistent terminology. They are now trying to find out what the market thinks: should the distinction between Article 8 and 9 funds remain, should we introduce a product labeling regime instead, or should we keep to a disclosure regime and introduce in addition a product labeling regime? We have no idea where the commission will come out, but it looks probable that some kind of labeling regime is coming."

Volhard says the commission could say, for example, that in order to be classified as an impact fund you must invest within certain parameters, meet certain quality standards and align a certain percentage of your investments to the taxonomy. "My hope is that if they go down the labeling route, which is likely, they don't replace what we currently have but introduce something optional for those that want to go down that route."

Compliance burden

Impact investors have already dedicated a lot of time and resource to SFDR compliance since the regulation came into effect in 2021. Michael Raymond, a partner at Travers Smith, says: "Ideally what we would want to see in the event of any SFDR reforms is a recognition that we've had lots of uncertainty. If we do end up with changes to Article 8, 8-plus and 9 classifications and key definitions, we need grandfathering so we are not disrupting existing funds with any new rules applying on a go-forward basis within the existing framework.

"It is perfectly possible we will end up with a labeling regime. That starts to look a lot like what the Financial Conduct Authority is proposing for UK retail funds, which is a disclosure regime for all products and then product labels that can be used on an optional basis."

The UK's FCA has made proposals for retail funds that set out three specific types of sustainable product, distinguishing between those with a sustainable focus, sustainable improvers or sustainable impact. If introduced, there is a good chance institutional investors will ask other sponsors to comply with the same terminology.

Regional divergence

Meanwhile, the US Securities and Exchange Commission is taking its own approach. Alexandra Farmer, a partner with Kirkland & Ellis in Washington, DC, says: "Right now the proposed ESG disclosure rules from the SEC are focused on process and disclosures, which is really the same as SFDR. The EU Taxonomy, however, is more about classification of activities, and we don't have anything like that in the US or see anything that is outcomes-focused coming any time soon."

The SEC's focus is very much around transparency on risk and in relation to the investment process, explains Farmer. "GPs are also dealing with some tensions from an anti-ESG perspective, and where the two meet in the middle is in a desire for transparency and an anti-greenwashing focus. That will remain the priority, and the regulatory focus will shift from there depending somewhat on the growth of the impact investing market as regulators seek to address issues that are material to investors."

Farmer points out that the SFDR has so far led the way on the global regulation of impact, so any potential changes will have a widespread effect. "Most of our US GPs are seeking capital from EU LPs, so they are subject to the SFDR regime directly or, if not, then indirectly through requests from their LPs. Over the last few years, it has been very influential in terms of how ESG and impact programs and strategies have developed, driven by investor expectations around SFDR and what GPs can reasonably commit to.

"This most recent consultation is creating further uncertainty at a time when managers who have spent resources building their programs around existing guidance may prefer to be going into compliance mode."

Goodwin partner Patrick Deasy also notes a divergence in regulatory approaches between the US and Europe: "The US approach to date has been to say that sustainability and impact are like any other investment strategy that sponsors are looking to promote to investors, so the important thing is that managers are fair, clear and not misleading. The EU, on the other hand, sees the regulatory regime as a means of coalescing capital into the climate impact space by providing a gold standard regulatory regime that investors can take a lot of comfort in and that also seeks to stamp out greenwashing."

"A lot of managers have invested in systems, marketing materials and reporting processes that feed into the existing regime"

PATRICK DEASY
Goodwin

When it comes to impact investing, the direction of travel is toward more rather than less regulation, particularly in Europe, says Deasy.

However, he adds: "My guess would be that the EU and the industry will try to work with what we have got under the SFDR, rather than completely overhauling it, because a lot of managers have invested in systems, marketing materials and reporting processes that feed into the existing regime."

For now, funds need to focus on providing clarity to investors, says Travers Smith's Raymond: "What is really important at this stage is being clear with your investors about your ESG and impact proposition, so it is not about your proposition chasing evolving regulation and labeling globally and instead the regulation overlays the manager's specific impact program."

Managers may also want to consider how they work with portfolio companies on these issues, says Debevoise's Volhard. "In order to be an Article 9 impact fund you already have to pass these tests that are quite comprehensive, so you are in good shape. Maybe the next step is to think about getting taxonomy aligned: many clients want to be taxonomy aligned but the companies they are investing in are not there yet on the data. My advice would be to start with Article 9 and work with companies towards getting a certain percentage of the portfolio taxonomy aligned." ■

Appointments **The hires that made our headlines**

NLC bolsters senior ranks

NLC has hired two professionals with fund finance experience to boost its senior ranks.

The specialist lender has added Tim Steele, a 16-year veteran at AIG, as a partner and investment committee member. Separately, NLC has also brought on Robby Koreman as an investor relations director. He previously had worked at PGB.

Most recently, Steele was a managing director at AIG and headed the structured alternatives team at a European division of the company. He added fund finance in 2018 as a new asset class and helped build a portfolio of NAV financing and subscription lines with an equivalent value of around $2 billion, NLC noted. Steele's responsibilities at AIG included structuring, trading and portfolio management.

Koreman is tasked with investor relations and fundraising efforts with European institutional investors and will be responsible for portfolio management. He had spent two years at PGB, serving as its treasury and team rates lead and as a portfolio manager for alternative fixed income.

Alter Domus names new COO

Luxembourg-based fund administrator Alter Domus has hired Michael Janiszewski as its chief operating officer.

Janiszewski will be based in New York and report to CEO Doug Hart. He will also serve as a member of the group executive board.

He replaces Tim Houghton, who remains with the firm as product strategy director in Luxembourg.

Janiszewski joins Alter Domus from BNY Mellon, where he was chief operating officer for the securities services and digital businesses. He also currently serves as a strategic partner at Aquila Equity Partners.

EverBank lands five

EverBank is building out its fund finance arm with five hires.

The bank said it added four of the five as directors: Gabrielle Buckner, Chris Grier, Storey Whalen and Alexa Schult. The fifth, Ryan Burke, has joined as vice-president.

Buckner previously worked at Wells Fargo as a director and has a decade of experience, while Burke was also with the bank and joins with a five-year industry track record. Jeff Johnston, EverBank's fund finance co-head, founded and headed up Wells Fargo's fund finance division.

Schult and Whalen previously worked at First Republic. Whalen was most recently a senior director and has a seven-year track record, while Schult was previously a director and has a decade of experience.

Grier has 12 years of industry experience, having previously worked at Silicon Balley Bank and at Bank of America. EverBank was previously known as TIAA Bank and was carved out of TIAA this past summer. The bank brought on Johnston and Mike Mascia, a former Cadwalader attorney who chaired its finance practice, to run its fund finance division. ■

Butterfly names new CFO

Los Angeles-based private equity firm Butterfly has named Peter Tang its new CFO.

Tang has been with Butterfly since its inception in 2016, most recently as a managing director. He replaces Nestor Olmo, who left the firm in February to join Sunston Partners as CFO.

Tang has also been appointed to the board of the Butterfly Equity Foundation, which provides greater access to nutritious and affordable food for underserved populations. Butterfly's general partners made an ongoing pledge to contribute 10 percent of their net profits in addition to outside funds from individual and corporate donors.

Previously, Tang worked at KKR as an investor on the consumer retail private equity team. Butterfly was launched in 2016 by former KKR executive Adam Waglay and Dustin Beck, a former Vista Equity Partners executive.