HMA | HEALTHY MARKETS ASSOCIATION

A MEMBER ORGANIZATION

January 12, 2023

Via Electronic Mail

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, File No. S7-03-22

Dear Ms. Countryman:

The Healthy Markets Association[1] writes to supplement our prior comments on the Commission's above-referenced proposal to better protect investors, as well as promote transparency and market efficiencies in the private funds ("Proposal").[2]

We previously offered support for each of the key elements of the Proposal, including requiring quarterly statements and audits designed to ensure the integrity of the valuation processes.

In particular, we wish to highlight how some elements of the Proposal could have better protected investors and markets from recent high-profile capital markets failures, including FTX, if they had been enacted years ago.

Considerations Regarding FTX

Under the auspices of promoting "capital formation," the Commission and Congress have repeatedly repealed disclosure and accountability obligations on companies and

[1] The Healthy Markets Association is a not-for-profit member organization focused on improving the transparency, efficiency, and fairness of the capital markets. Healthy Markets promotes these goals through education and advocacy to reduce conflicts of interest, improve timely access to market information, modernize the regulation of trading venues and funding markets, and promote robust public markets. Its members include public pension funds, investment advisers, broker-dealers, exchanges, and data firms. As a result, HMA members would be directly impacted by the Proposal. To learn more about HMA or our members, please see our website at http://healthymarkets.org/about. The views expressed in this letter are those of HMA, and do not necessarily reflect all of the views of all HMA members.

[2] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, SEC, 86 Fed. Reg. 16886 (Mar. 24, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf ("Proposal"). See also, Letter from Tyler Gellasch, HMA, to Vanessa Countryman, SEC, Apr. 15, 2022, *available at* https://www.sec.gov/comments/s7-03-22/s70322-20123868-280038.pdf.

funds seeking to raise money from investors.[3] As the recent debacle with FTX and other large, private firms have highlighted, the removal of regulatorily-imposed financial transparency and corporate accountability can be disastrous.

FTX's Rise Was Fueled by Private Venture Capital Funds

As the Commission scrutinizes the facts leading to the FTX disaster, it should not ignore the capital markets ecosystem that made FTX possible. Before FTX collapsed, it was funded by sophisticated US investment advisers who made their investments through securities offered in reliance on exemptions from the securities laws. Many of these investment advisers are professional venture capitalists and private equity investors.

Prior to FTX's launch, Alameda Research was established by Sam Bankman-Fried and other junior traders with backgrounds in trading traditional financial products. In 2018, Alameda Research sought outside investors to help fund its trading, which reportedly included a 6-page pitch deck to potential investors.[4] The deck raises significant red flags, including that it dedicated just three pages dedicated to describing the investment and one of its claims was to guarantee a 15 percent return with no risk.[5]

FTX was reportedly launched in May 2019 as an offshoot of Alameda Research. Over the next two years, private fund investment advisers along with other sophisticated private market investors provided approximately $2 billion in capital to FTX through several rounds of financing claiming skyrocketing valuations.

In mid-2020, FTX reportedly closed its Series A round with a valuation pegged at $8 billion.

In July 2021, FTX announced that FTX Trading Ltd. had closed a Series B round, raising $900 million from over 60 investors, including many of the most prominent venture capital firms and investors in the world: Altimeter, Circle, Coinbase Ventures, Sequoia, SoftBank, Third Point, Thoma Bravo, and VanEck. It also included some well-known market participants, such as Izzy Englander and Hudson River Trading.[6] At the time, the company stated that the deal was negotiated by its own ventures team,

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[3] Healthy Markets Association, *In the Public Interest: Why Policymakers and Regulators Must Restore the Public Capital Markets*, Jan. 2022, *available at* https://healthymarkets.org/product/public-vs-private-markets-a-special-report.

[4] Frank Chaparro, *Alameda promised 'high returns with no risk' in 2018 pitch*, The Block, Nov. 11, 2022, *available at* https://www.theblock.co/post/186187/alameda-promised-high-returns-with-no-risk-in-2018-pitch.

[5] Frank Chaparro, *Alameda promised 'high returns with no risk' in 2018 pitch*, The Block, Nov. 11, 2022, *available at* https://www.theblock.co/post/186187/alameda-promised-high-returns-with-no-risk-in-2018-pitch.

[6] Press Release, *FTX Trading Ltd. Closes $900M Series B Round -- Largest Raise in Crypto Exchange History*, FTX Trading Ltd., July 20, 2021, *available at* https://www.prnewswire.com/news-releases/ftx-trading-ltd-closes-900m-series-b-round----largest-raise-in-crypto-exchange-history-301337709.html ("July 2021 Fundraise Announcement").

"with help from Paradigm, Ribbit, and BTIG."[7] The new valuation was pegged at $18 billion.[8]

Just three months later, October 2021, FTX announced that FTX Trading Ltd. had closed a Series B-1 round, raising over $420 million from 69 investors, including Sequoia Capital, Sea Capital, IVP, ICONIQ Growth, Tiger Global, Ribbit Capital, Lightspeed Venture Partners and funds and accounts managed by BlackRock.[9] The new valuation was pegged at $25 billion, a nearly 40% increase.[10]

In January 2022, FTX US announced that it had closed a Series A round of financing for West Realm Shire Services, which is the legal entity for FTX US. That raise was for $400 million from several investors, including Paradigm, NEA, Multicoin Capital, Tribe Capital, SoftBank Vision Fund 2, Greenoaks Capital, Steadview Capital, and Lightspeed Venture Partners.[11] The valuation of FTX US (the US entity only) was pegged at $8 billion.[12]

Days after completing the fundraise for FTX US, FTX Trading Ltd. announced that it had closed its own Series C round, raising $400 million from several investors, including, Paradigm, NEA, IVP, SoftBank Vision Fund 2, Lightspeed Venture Partners, Steadview Capital, Tiger Global, and Insight Partners.[13] The company's new valuation was pegged at $32 billion, more than 25% above what it was just three months earlier.[14]

FTX's Curious Use of Funds and Lack of Controls

Nine and a half months after raising hundreds of millions of dollars at a $32 billion valuation, FTX collapsed. On November 11, 2022, FTX Trading Ltd and dozens of its related entities filed for bankruptcy. Documents submitted as part of that bankruptcy proceeding clearly detail significant operational and financial failures by FTX and its

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[7] July 2021 Fundraise Announcement.
[8] July 2021 Fundraise Announcement.
[9] Press Release, *FTX Trading Ltd. Closes $420 Million Series B-1 Funding Round*, FTX Trading Ltd., Oct. 21, 2021, *available at* https://www.prnewswire.com/news-releases/ftx-trading-ltd-closes-420-million-series-b-1-funding-round-301405473.html ("October 2021 Fundraise Announcement"). The October 2021 fundraising also included Ontario Teachers' Pension Plan Board, via its Teachers' Innovation Platform and the Singapore government's investment and holding company, Temasek Holdings Limited.
[10] October 2021 Fundraise Announcement.
[11] Press Release, *FTX US Closes $400M Series A Round*, FTX US, Jan. 26, 2022, *available at* https://www.prnewswire.com/news-releases/ftx-us-closes-400m-series-a-round-301468435.html ("January 2022 FTX US Fundraise Announcement").
[12] January 2022 FTX US Fundraise Announcement.
[13] Press Release, *FTX Trading Ltd. Closes $400M Series C Round*, FTX Trading Ltd., Jan. 31, 2022, *available at* https://www.prnewswire.com/news-releases/ftx-trading-ltd-closes-400m-series-c-round-301471084.html. ("January 2022 Global Fundraise Announcement").
[14] January 2022 Global Fundraise Announcement.

executives.[15] New FTX CEO John J. Ray III, an experienced corporate restructuring expert, submitted to court the following:

> I have over 40 years of legal and restructuring experience. I have been the Chief Restructuring Officer or Chief Executive Officer in several of the largest corporate failures in history. I have supervised situations involving allegations of criminal activity and malfeasance (Enron). I have supervised situations involving novel financial structures (Enron and Residential Capital) and cross-border asset recovery and maximization (Nortel and Overseas Shipholding). Nearly every situation in which I have been involved has been characterized by defects of some sort in internal controls, regulatory compliance, human resources and systems integrity. Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. ***From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented.*** (emphasis added)[16]

While the bankruptcy filings disclosed new information about FTX's poor controls and recordkeeping, other signs of significant corporate dysfunction had long been public.

For example, FTX apparently never had a Chief Financial Officer.[17] This should be particularly noticeable for investors, since CFOs typically play crucial roles in corporate fundraisings.

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[15] *See, e.g.*, *In re FTX Trading Ltd,* Emergency Motion Pursuant to Fed. R. Bankr. P. 1014(B)(I) to Transfer Chapter 15 Proceeding Relating to FTX Digital Markets Ltd and (II) For a Stay, Case No. 22-11068 (JTD), USBC Del. Nov. 17, 2022, *available at* https://pacer-documents.s3.amazonaws.com/33/188450/042120648186.pdf.

[16] *Here Are the Wildest Parts of the New FTX Bankruptcy Filing*, Bloomberg Tax, Nov. 17, 2022, *available at* https://news.bloombergtax.com/financial-accounting/here-are-the-wildest-parts-of-the-new-ftx-bankruptcy-filing (citing bankruptcy court filings).

[17] Ledger Insights, *FTX warning signs: no CFO when dealing with billions of client money*, Nov. 11, 2022, *available at* https://www.ledgerinsights.com/ftx-warning-signs-no-cfo/.

FTX did have a Chief Operating Officer, but her LinkedIn profile suggests that she graduated from college in 2016 and had just two years experience in risk management.[18]

In addition, FTX appears to not have included its customer liabilities on its balance sheet – an omission that would likely have been obvious to any accountant. However, it doesn't appear as though FTX had an accountant on staff – an issue that appears to have only received public attention in recent days.

The corporate deficiencies continue.

According to Jay, FTX didn't have "an accurate list of bank accounts and account signatories;" approved or denied employee expense requests via emojis, not formal systems; and may have even approved use of funds and credit for the personal expenses or corporate personnel, such as funding multiple home purchases and other significant non-business items in the Bahamas.[19]

Then again, identifying improper expenses and payments may be difficult because it's not clear how many employees FTX had (or who they were). Estimates are that the company had about 300 on payroll, but the employment records apparently aren't reliable.

The red flags didn't stop there.

Further mysteries also surround the company's "use of funds." FTX investors presumably knew that their money would help fund significant advertising costs, such as payments to support (i) celebrity promotions with Tom Brady, Gisele Bundchen, and Steph Curry, (ii) naming rights to the Miami Heat arena, and (iii) logos on uniforms for Major League Baseball umpires. But were investors aware of other significant expenditures?

One series of questions surrounding FTX has been about its physical presence. Where is it? And what funds have been used in these locations? In May 2022, FTX opened a new US headquarters in Chicago, in a high profile ribbon-cutting ceremony with Chicago Mayor, Lori Lightfoot.[20] However, just four months later, FTX's CEO announced

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[18] Tweet, @AnaMostarac, Nov. 14, 2022, *available at* https://twitter.com/anammostarac/status/1592346187553968129.

[19] Koh Gui Qing, *Bankman-Fried's FTX, senior staff, parents bought Bahamas property worth $300 mln*, Reuters, Nov. 22, 2022, *available at* https://www.reuters.com/technology/exclusive-bankman-frieds-ftx-parents-bought-bahamas-property-worth-121-mln-2022-11-22/.

[20] CBS Chicago, *FTX cryptocurrency exchange opens new headquarters in Chicago*, May 10, 2022, *available at* https://www.cbsnews.com/chicago/news/ftx-cryptocurrency-exchange-opens-new-headquarters-in-chicago/.

that he was moving FTX US headquarters from Chicago to Miami.[21] What was the justification for the move, and what did it cost? At the same time, FTX apparently spent lavishly on its international headquarters in the Bahamas. But did its investors know that their capital was being used to build the badminton courts at the new Bahamas headquarters? Were corporate funds used to buy homes in the Bahamas for FTX officials and their family members?[22]

Did investors know that billions of FTX funds would be lent to Alameda Research? Did the "sophisticated" investors know that $300 million from one round of capital raising was reportedly used to help cash out FTX's CEO?[23]

We are puzzled why none of these obvious misallocations of funds ever surfaced in connection with the various entities' audits, much less the due diligence by or disclosures to investors. Put simply, the auditors of FTX, including Prager Metis and Armenino,[24] also appear to have proven to be materially deficient. These events not only reveal, but condemn, the audit standards applicable to private – as opposed to public – companies.

Setting aside the self-dealing and other control problems surrounding the use of investors' funds, there also appears to be very significant concerns regarding the company's use of its customers' funds.

A few days after FTX filed for bankruptcy, its former CEO attempted to explain what happened in a bizarre Tweet-thread spanning several days. While we are cautious about relying on any of his claims, we find the following tweet simply astounding.

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[21] Cheyenne Ligon, *Crypto Exchange FTX Is Moving Its US Headquarters From Chicago to Miami*, CoinDesk, Sept. 27, 2022, *available at* https://www.yahoo.com/now/crypto-exchange-ftx-moving-u-185216362.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAG2_hDJBCMMxFxIdy8AnHGZpvKHaoVA_jt-HBYSCt3fDsCNfvlrwIaKpSjS5lb-KbGPvfuO0NbUym_-Fir7XXUB_10-cnsuVs9aT-RtFC1Nf6J6aFk8jynEmiw68z3XKA7dLtE3Y9dgtr1Pge3D-vVvjnLZZY0dkHc_CHrwgKY2N.

[22] Koh Gui Qing, *Bankman-Fried's FTX, senior staff, parents bought Bahamas property worth $300 mln*, Reuters, Nov. 22, 2022, *available at* https://www.reuters.com/technology/exclusive-bankman-frieds-ftx-parents-bought-bahamas-property-worth-121-mln-2022-11-22/.

[23] Eliot Brown, Caitlin Ostroff, and Berber Jin, *FTX's Sam Bankman-Fried Cashed Out $300 Million During Funding Spree*, Wall St. J., Nov. 18, 2022, *available at* https://www.wsj.com/articles/ftxs-sam-bankman-fried-cashed-out-300-million-during-funding-spree-11668799774.

[24] Stephen Foley, *FTX collapse puts its auditors in the spotlight*, Financial Times, Nov. 13, 2022, *available at* https://www.ft.com/content/930c6cea-5457-4dfa-9d47-666c0698c335.

> **SBF** @SBF_FTX · Nov 16
>
> 23) Roughly 25% of customer assets were withdrawn each day--$4b.
>
> As it turned out, I was wrong: leverage wasn't ~$5b, it was ~$13b.
>
> $13b leverage, total run on the bank, total collapse in asset value, all at once.
>
> Which is why you don't want that leverage.
>
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If we take his statement at face value, the CEO of a private company owned by dozens of arguably the most sophisticated investors in the world was "wrong" on how much leverage the company had taken by a mind-boggling $7 billion. That material miscalculation could not be possible had there been any reasonable financial controls supporting a transparent and reliable financial reporting system staffed by experienced professionals that was audited by truly independent professionals.

Investment Advisers' Role in FTX's Rise and Fall

Investment advisers who chose to invest their funds in FTX are likely to rightly face their own board inquiries, private plaintiff complaints, and regulatory scrutiny regarding their own diligence and warning signs they missed.[25] Despite multiple red flags, weak or absent financial information, and an invisible CFO, private venture capital fund advisers who would be subject to the Proposal decided to collectively invest billions of dollars in FTX.

Ultimately, those investment advisers appear to have failed to:

- conduct adequate due diligence when evaluating FTX's financial condition, controls, and prospects, which suggests they had failed to implement adequate investment policies, procedures, and practices; and
- accurately assess the values of their positions in FTX, which suggests material failures to implement adequate policies, procedures, and practices relating to fair valuations of its portfolio holdings.

Aside from impacting their own fortunes, those investment advisers' missteps resulted in retirees and other beneficial owners losing millions of dollars. Moreover, they provided the fuel to FTX's rapid and reckless expansion, which endangered billions of dollars of its customers' assets. In fact, following FTX's collapse, many of its customers have noted that the long list of leading financial backers of FTX materially contributed to

[25] Erin Griffith and David Yaffe-Bellany, *Investors Who Put $2 Billion Into FTX Face Scrutiny, Too,* N.Y. Times, Nov. 11, 2022, *available at* https://www.nytimes.com/2022/11/11/technology/ftx-investors-venture-capital.html.

their decisions to trust the company. The investment decisions by a handful of investment advisers to private venture capital funds conferred an aura of legitimacy upon FTX that caused its harm to continue and exponentially grow.

FTX Implications Due Diligence Obligations

For several years now, digital assets and financial intermediaries engaging in trading those assets have been treated as "hot" private investments. Rather than scrutinizing FTX, investment advisers to private venture capital funds were essentially cheerleaders.[26]

In what should have been seen as another startling red flag, FTX's own venture capital investing arm appears to have flagrantly disregarded prudent investment practices in search for dramatic returns. FTX's in-house venture arm was led by a former executive of Lightspeed Venture Partners, a private venture capital fund adviser that invested in FTX, and would likely be subject to the Proposal.[27]

Just last month, that former executive noted that venture investment term sheets with companies were often signed within 24 hours.[28] In fact, when FTX launched its venture arm, it affirmatively advertised to potential portfolio companies that "[w]e don't mind if you're anon. We won't ask you to present in front of an investment committee."[29]

What kind of due diligence can be performed in 24 hours? How deep can investment advisers go, and how could it perform even basic due diligence without knowing who it is funding? What does anti-money laundering look like? What does sanctions compliance look like? What does reasonable accountability (or fiduciary duty) even look like?

Nevertheless, even in an irresponsibly compressed 24 hours, investment advisers conducting due diligence might have noticed the absence of customer liabilities on a balance sheet or the absence of any accountants or a CFO. Given the emerging facts, it is hard to credit Sequoia's recent statement that it "ran a rigorous due diligence process."[30]

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[26] *See, e.g.*, Adam Fisher, *Sam Bankman-Fried Has a Savior Complex—And Maybe You Should Too*, Sequoia, Sept. 22, 2022, *archive available at* https://web.archive.org/web/20221109230422/https://www.sequoiacap.com/article/sam-bankman-fried-spotlight/.

[27] Kate Clark, *FTX Ventures Head Amy Wu Resigns*, The Information, Nov. 11, 2022, *available at* https://www.theinformation.com/briefings/ftx-ventures-head-amy-wu-resigns.

[28] Ryan Weeks and Frank Chaparro, *FTX pitch deck projections not backed by 'viable assumptions,' legal expert says*, The Block, Nov. 18, 2022, *available at* https://www.theblock.co/post/188264/ftx-pitch-deck-projections-not-viable.

[29] *Id.*

[30] Sequoia, Nov. 9, 2022, *available at* https://twitter.com/sequoia/status/1590522718650499073/photo/1 (noting that Sequoia had invested in FTX.com and FTX US through its Global Growth Fund III with a cost

FTX Implications for Private Investment Valuations

Just six months ago, Sam Bankman-Fried gave an interview with Odd-Lots in which he candidly described the capital formation process in a way that should send shivers up the spine of every investor and regulator.[31] According to the former FTX CEO:

> You get a bizarre f—ing process that does not look like the paragon of efficient markets that you might expect. [Venture capitalists] see what all their friends are chattering about, and their friends keep talking about this company…and they start FOMOing and then [they] find a way to get into that….
>
> And all the while, you're like, 'How do we justify: Is this a good investment? Like, all the models are made up…. You're valuing [companies] off a model built by a person who owns the thing that's being sold. So, like, of course the number's going to go up between now and 2025, right? It's going to go up an arbitrary amount. And you can justify anything.

That bizarre and arbitrary valuation process condemned by the former FTX CEO appears to be exactly what happened with FTX itself. As explained above,

- from mid-2020 to July 2021, the company's "valuation" based on funding rounds went from $8 to $18 billion;
- from July 2021 to October 2021, it's "valuation" based on funding rounds went from $18 billion to $25 billion; and
- from October 2021 to January 2022, it went from $25 billion to $32 billion.

The skyrocketing valuations for FTX, which quadrupled in less than two years in an untested company handling novel, volatile products with significant risks was only possible because of a longstanding practice within the venture capital fund industry of pretending that the "fair value" of a company can be based on the percentage interest most recently sold, the price for that interest, and then extrapolating to cover the full "value" of the company.

Notably, that is not how a hedge fund that invests in public equities would typically "value" its portfolio. Far from it.

Nor is that how registered investment companies generally determine the values of their holdings. To the contrary, registered investment companies are subject to detailed

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basis of $150 million). Notably, the firm did not disclose what valuation it had been carrying the positions at, prior to writing them down to $0.

[31] Odd-Lots, *Sam Bankman-Fried and Matt Levine on How to Make Money in Crypto*, Apr. 25, 2022, *available at* https://omny.fm/shows/odd-lots/sam-bankman-fried-and-matt-levine-on-how-to-make-m.

valuation rules designed by the Commission to ensure their illiquid holdings – such as holdings in FTX – are assigned evidence-based, good faith values.[32]

In particular, registered investment companies are required to use the "market value of their portfolio securities when market quotations are 'readily available,' and, when a market quotation for a portfolio security is not readily available …, by using the investment's fair value, as determined in good faith."[33] Furthermore, registered investment companies must also set up internal procedures to regularly assess and validate their valuations.[34]

Unfortunately, those valuation requirements do not generally apply to investment advisers to private funds who would be impacted by the Proposal. As our April letter explained,

> The risk of intentional or unintentional mis-valuation is often significantly greater for private funds. At the same time, the fee and expense structures for many private funds often provide even greater incentives for potential over-valuations. So while the valuation risks and incentives are skewed more heavily against investors in private funds, the protections are qualitatively lower.
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> Absent a comprehensive fair valuation rule akin to what is required for registered investment companies, at a bare minimum, the Commission should require private fund processes related to valuations, performance, fees, and expenses to be audited, as well as require fund financial statements to be prepared in accordance with GAAP.[35]

Were investment advisers to venture capital funds required to use robust due diligence and valuation processes, FTX's abrupt rise and fall, with its profound impacts on investors, customers, and millions of other market participants, simply would not have

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[32] See *Good Faith Determinations of Fair Value*, SEC, 86 Fed. Reg. 748, 784 (Jan. 6, 2021), *available at* https://www.govinfo.gov/content/pkg/FR-2021-01-06/pdf/2020-26971.pdf ("[P]proper valuation promotes the purchase and sale of fund shares at fair prices, and helps to avoid dilution of shareholder interests. Furthermore, investors may have stronger assurance that they can rely on valuations to express the risk and return profile of a fund, making investors' decisions better informed. Thus, investors may be better able to evaluate a fund and consider whether a fund fits into their investment goals in terms of returns and risk (e.g., ability and willingness to bear risk). Improper valuation can cause investors to pay fees that are too high or to base their investment decisions on inaccurate information.") ("Fair Value Rule Revision").
[33] *Id.,* at 748.
[34] *Id.*, at 749.
[35] Letter from Tyler Gellasch, HMA, to Vanessa Countryman, SEC, Apr. 15, 2022, *available at* https://healthymarkets.org/wp-content/uploads/2022/04/Letter-to-SEC-re-Private-Funds-4-15-22vf.pdf.

happened. The damage inflicted upon the underlying customers of these venture capital funds would also have been minimized.

In addition, it is important to note that the due diligence and illiquid securities valuation problems with private fund holdings are not confined to FTX or digital asset companies. As the Wall Street Journal recently observed, even as the public markets have fallen this year, private fund "valuations overall have remained relatively high as managers wait for events like new funding rounds or public offerings to revalue their private investments."[36] Put simply, we welcome the reported Commission staff inquiries and investigations into due diligence exercised by private venture capital fund advisers in connection with FTX, and we hope that such inquiries are sufficiently broadly scoped to appropriately cover that industry.[37]

FTX Implications for Quarterly Statements

In addition to due diligence and valuation issues, the FTX collapse has shined a harsh light on how little transparency many pensions, universities, and other private fund investors may have into their holdings. In fact, after the FTX crash, some pension fund investors indicated that they did know the extent to which they were invested in or otherwise exposed to FTX or other at-risk private companies in the digital asset ecosystem.

As we wrote in April,

> Some private fund advisers currently provide statements to investors, while others do not.[38] Periodic statements (which are often monthly or quarterly) may be provided to some investors, and information provided in some statements may not be provided to others. … As a result, larger, more sophisticated investors often receive the most useful information in a timely manner, while smaller, less sophisticated investors often receive less timely and complete information. In part because the information provided to investors is often different, individual investors are typically unable to reconcile fund holdings, valuations,

[36] Juliet Chung and Melissa Korn, *After Record Year, University-Endowment Returns Drop Into Negative Territory*, Wall St. J., Oct. 31, 2022, *available at* https://www.wsj.com/articles/after-record-year-university-endowment-returns-drop-into-negative-territory-11667188753. Obviously, these distortions are far more possible – and likely – if the private funds' holdings are illiquid instruments or private securities, as opposed to public, liquid assets.

[37] *See, e.g.*, Chris Prentice, *U.S. securities regulator probes FTX investors' due diligence -sources*, Reuters, Jan. 6, 2023, *available at* https://www.reuters.com/technology/us-securities-regulator-probes-ftx-investors-due-diligence-sources-2023-01-05/.

[38] Chung and Korn.

> performance, fees, and expenses against what is contained in their limited partnership agreements or side letters.[39]

The Commission should require private fund advisers to provide quarterly statements to each investor, so that all investors can have an accurate understanding of its holdings, values, risks, and costs. Even investors who currently receive periodic reports would benefit from the enhanced and standardized policies, procedures, and practices that would likely emerge across the private fund industry to ensure the quality and consistency of new mandatory disclosures.

FTX Implications for Mandatory Audits

Finally, the FTX collapse illustrates the importance of the provision in the Proposal that would "require private fund advisers to obtain an annual audit of the financial statements of the private funds they manage."[40] The audit would have to be performed by an "independent public accountant" and financial statements would have to be "prepared in accordance with U.S. Generally Accepted Accounting Principles."[41]

If that audit requirement had been in place, it would have helped constrain the fundraising and consequential damage caused by FTX. As our April comment letter explains, current practices place upward pressure on private fund holdings valuations:

> Regular audits are extremely valuable to all investors in private funds … because a truly independent audit by an independent public accountant would provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees.[42] An independent check on the valuation methodologies, practices, and outcomes is essential to assessing not just a fund's performance, but also its fees. A private fund's adviser is often incentivized to exercise its discretion in favor of assessing potentially higher values to a fund's illiquid investments, as the fund's fees are often directly tied to those valuations.[43]

FTX is a real-life demonstration of how a company with poor financial statements, no audits, and high-risk assets and practices engaged in fundraising rounds that led to ever-higher valuations. The basis for the FTX valuations is difficult to understand, must less justify. Private market investors have already noted how auditor oversight can lead to more accurate valuations. Just weeks ago, for example, the head of Harvard's

[39] HMA Comment Letter, at 4-5.
[40] Proposal, at 16911.
[41] *Id.*
[42] *Id.*
[43] HMA Comment Letter, at 6.

endowment noted that better-than-expected performance numbers generally didn't reflect year-end, auditor-demanded writedowns of the less-liquid, private fund holdings.[44]

Common sense suggests that valuations in private fund holdings will be far more accurate when someone who is legally bound to practice professional skepticism makes a probing inquiry into the justification for an asserted valuation. More accurate valuation can also have significant impacts on investors. They often impact fees, but they can also impact projected returns.

For example, while Sequoia has recently identified its cost basis for its investments in FTX, and disclosed that it had written its FTX holdings down to $0, it hasn't yet publicly disclosed what it was telling its private fund investors the valuations were as of September 30, 2022. It is likely that investors were told that their "unrealized gains" were much more than $0. To what extent were investors in Sequoia and other private venture capital funds investing in FTX reflecting those valuations in their own portfolios, such as in a pension fund funding status? While the cost-basis losses may seem minimal, the overall net impact on a specific pension fund, university, or other private fund investor may not be.

For those investors, it is not unlike buying a $10 lottery ticket, being told you won, borrowing millions against the winning ticket, buying a house with that loaned money, and then discovering that you actually didn't win. Your real losses may be much greater than $10.

Requiring private funds to undergo audits wouldn't just help investors, of course, but also the funds' portfolio companies. Audits of private funds can help drive the establishment of policies, procedures, and practices at their portfolio companies that can improve transparency, enhance internal controls, and reduce risks.

FTX Implications for Other Commission Rulemakings

Lastly, we note that there are many other significant opportunities for regulatory improvement that have been raised by the FTX debacle, many of which are currently under consideration at the Commission. For example, the Commission should revise:

- its interpretation of "holder of record" to more accurately count beneficial owners of securities, which would pull many more companies into the public reporting and accountability regime, and

[44] Antoine Gara, *Harvard predicts looming markdowns to private fund holdings*, Financial Times, Oct. 13, 2022, *available at* https://www.ft.com/content/e00fd280-3863-4a12-8dc5-017058590ebe.

- valuation practices used by private funds so as to ensure portfolio securities are more fairly and accurately valued.

Conclusion

Today, millions of pensioners and other investors rely upon private fund advisers to not just exercise basic due diligence, but also fairly and accurately identify their holdings and risks, and assess their fees and expenses. With respect to FTX at least, their trust appears to have been abused.

The Proposal, and particularly the proposed requirements for quarterly statements and audits, would impose needed discipline on investment advisers in private funds that, in turn, could lead to greater discipline and accountability for private firms like FTX. Thank you for the opportunity to supplement our comments on the Proposal.

Sincerely,

Tyler Gellasch
President and CEO