WINSTON & STRAWN LLP

CLIENT ALERT

SEC Risk Alert: Certain Compliance Issues for Private Fund Advisers

FEBRUARY 4, 2022

On January 27, 2022, the Division of Examinations ("EXAMS") of the Securities and Exchange Commission ("SEC") released a Risk Alert ("Risk Alert")[1] relating to certain compliance issues observed by EXAMS during examinations of registered investment advisers that manage private funds (referred to in the Risk Alert collectively as "private fund advisers"). The Risk Alert serves in part as an update to a similar risk alert relating to private fund advisers that was issued by the SEC's Office of Compliance Inspections and Examinations (EXAMS's prior name) in June 2020.[2]

The Risk Alert reminds private fund advisers of their fiduciary duties to clients and focuses on four general topics. These topics are: (i) failure to act consistently with disclosures; (ii) use of misleading disclosures regarding performance and marketing; (iii) due diligence failures relating to investments or service providers; and (iv) use of potentially misleading "hedge clauses."

While the Risk Alert does not establish new regulatory obligations, the items discussed in the Risk Alert may serve as a useful roadmap of potential examination priorities and should be considered in connection with a private fund adviser's review of their compliance program and disclosures to private fund investors.

Key takeaways from the Risk Alert are that private fund advisers should adopt and maintain reasonably designed policies and procedures, implement and follow such policies and procedures, and make appropriate disclosures to fund investors.

Conduct Inconsistent With Disclosures

The Risk Alert discusses six general areas of conduct observed in examinations that were inconsistent with disclosures to investors.

Failure to obtain informed consent from Limited Partner Advisory Committees, Advisory Boards, or Advisory Committees (collectively, "LPACs") required under fund disclosures. Examples of this inconsistency include failures to follow practices described in limited partnership agreements, operating agreements, private placement memoranda, due-diligence questionnaires, side letters, and other disclosures, including failing to obtain consent for certain conflicted transactions from LPACs or obtaining consent after the transaction had occurred.

Failure to follow practices described in fund disclosures regarding the calculation of Post-Commitment Period fund-level management fees. The Risk Alert discusses that some private fund advisers have not reduced the cost basis of investments when calculating management fees after selling, writing off, writing down, or otherwise disposing of portions of an investment, while other private fund advisers used broad, undefined terms in their governing agreement, such as "impaired" or "written down," while not implementing policies and procedures reasonably designed to apply these terms consistently. The Risk Alert highlights that such failures have resulted in investors paying more in management fees than they were otherwise required to pay.

Failure to comply with LPA liquidation and fund extension terms. The Risk Alert highlights that some private fund advisers have engaged in practices such as extending the terms of private equity funds without obtaining the required approvals or without complying with the liquidation provisions otherwise set forth in their funds' governing agreements.

Failure to invest in accordance with fund disclosures regarding investment strategy. Examples in this category include instances of implementing an investment strategy that diverges materially from fund disclosures, such as funds exceeding leverage limitations detailed in fund disclosures.

Failures relating to recycling practices. The Risk Alert describes that some private fund advisers have not accurately described the "recycling" practices utilized by their funds or have otherwise omitted material information from such disclosures. The Risk Alert notes, further, that in some instances, these failures may have caused private fund advisers to collect excess management fees.

Failure to follow fund disclosures regarding adviser personnel. Examples in this category include private fund advisers not adhering to "key person" provisions set forth in the governing agreements of their funds, such as not providing accurate information to investors reflecting the status of key previously employed portfolio managers.

Disclosures Regarding Performance and Marketing

The Risk Alert describes four general areas of conduct observed in examinations that relate to disclosures regarding performance and marketing. The Risk Alert notes that many such areas of conduct appear to be violations of Advisers Act Rule 206(4)-8[3] and Advisers Act Rule 204-2(a)(16).[4]

Misleading material information about a track record. The Risk Alert notes how some private fund advisers have provided inaccurate or misleading disclosures about their track record, including how benchmarks were used or how their track record was constructed. Examples include cherry picking, not disclosing material information about the impact of leverage on performance, and failing to reflect fees and expenses accurately.

Inaccurate performance calculations. Examples in this category include private fund advisers using inaccurate underlying data (e.g., data from incorrect time periods, and projected rather than actual performance) when creating track records.

Portability. Examples of problematic portability matters cited by EXAMS include failure to support adequately, or omitting material information about, predecessor performance, including failures to maintain books and records supporting predecessor performance under Advisers Act Rule 204-2(a)(16), and using performance that persons at the adviser were not primarily responsible for achieving at the prior adviser.

Misleading statements regarding awards or other claims. The Risk Alert notes examples of private fund advisers making misleading statements regarding awards they received, and in many cases failing to disclose the criteria for obtaining them, the amount of any fee paid by the adviser to receive them, and any amounts paid to the grantor of the awards for the adviser's right to promote its receipt of the awards. Finally, the Risk Alert observed instances of private fund advisers that incorrectly claimed their investments were "supported" or "overseen" by the SEC or the United States government.

Due Diligence

The Risk Alert notes two general areas of conduct observed in examinations that relate to due diligence.

Lack of a reasonable investigation into underlying investments or funds. The Risk Alert notes that some private fund advisers have failed to perform reasonable investigations of investments in accordance with the adviser's policies and procedures. The Risk Alert also notes that some private fund advisers have failed to perform adequate due diligence on important service providers, such as alternative data providers and placement agents.

Inadequate policies and procedures regarding investment due diligence. EXAMS observed private fund advisers that did not appear to maintain reasonably designed policies and procedures regarding due diligence of investments. For example, the staff observed private fund advisers that outlined a due-diligence process in fund disclosures but did not maintain policies and procedures related to due diligence that were tailored to their advisory businesses.

Hedge Clauses

"Hedge clauses" are provisions in agreements or statements set forth in other disclosures to clients or private fund investors that purport to limit an adviser's liability. In certain instances, such provisions or statements may be misleading, and otherwise violate the anti-fraud provisions of the Advisers Act set forth in Sections 206(1) and 206(2) thereof. The Risk Alert notes that examinations have observed private fund advisers including potentially misleading hedge clauses in documents that purport to waive or limit their fiduciary duty under the Advisers Act to non-appealable judicial findings of gross negligence, willful misconduct, or fraud. The Risk Alert notes that such clauses could be inconsistent with the Advisers Act.

* * * *

We can be available at your convenience to discuss the matters addressed in the Risk Alert, as well as the ways such matters may affect your business.

---

[1] EXAMS's Risk Alert is available at https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf. Last accessed January 27, 2022.

[2] EXAMS's prior risk alert is available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf. Last accessed January 27, 2022. A link to Winston & Strawn's briefing on the prior risk alert is available at https://www.winston.com/en/thought-leadership/sec-issues-risk-alert-relating-to-observations-from-recent-examinations.html.

[3] Advisers Act Rule 206(4)-8 prohibits fraudulent actions by investment advisers to pooled investment vehicles, and expressly references fund investors and prospective fund investors.

[4] Advisers Act Rule 204-2(a)(16) requires registered investment advisers to maintain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of any performance or rate of return of any or all managed accounts or securities recommendations.

6 Min Read

Related Locations

Chicago | New York

Related Topics

Regulatory & Compliance | Investment Management | Private Fund Advisers

Related Capabilities

Transactions | Private Investment Funds | Financial Services Transactions & Regulatory

Related Regions

North America

Related Professionals

Basil Godellas

Beth Kramer