Observations from Examinations of Private Fund Advisers

February 2022

On Jan. 27, 2022 the SEC Division of Examinations issued a Risk Alert providing observations of examination staff relating to advisers to private funds. The Risk Alert provides additional observations in follow up to the Division of Examinations June 23, 2020 Private Fund Adviser Risk Alert.

The Jan. 27, 2022 Risk Alert details the following additional observations:

- Failure to act consistently with disclosures;
- Use of misleading disclosures regarding performance and marketing;
- Due diligence failures relating to investments or services providers; and
- Use of potentially misleading "hedge" clauses.

The Division of Examinations initially summarizes the legal and regulatory obligations applicable to advisers to private funds/advisers generally. Specifically, all SEC-registered investment advisers under the Investment Advisers Act of 1940 (Advisers Act) have a fiduciary duty to clients that entails a duty of care and a duty of loyalty. This combination of care and loyalty requires investment advisers to act in the best interest of clients at all times. In addition, pursuant to Advisers Act Rule 206(4)-7, all SEC- registered investment advisers must adopt and implement written compliance policies and procedures. Finally, Advisers Act Rule 206(4)-8 provides general anti-fraud requirements to advisers to pooled investment vehicles.

Conduct Inconsistent with Disclosures

- Failure to obtain required consent from limited partner advisory committees, advisory boards or advisory committees (the committees) required under fund disclosures.
    - The staff noted examples of private

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fund advisers failing to bring conflicts to committees for review and consent, as well as failing to timely obtain consents for certain conflicted transactions, in contravention of fund disclosures.

- Failure to follow practices described in fund disclosures regarding the calculation of post-commitment period fund-level management fees.
    - Advisers to private equity funds typically assess a management fee based on a percentage of limited partner capital commitments during the period of time the fund deploys capital – the commitment period. Generally, the basis of the amount used to calculate the fee is reduced to invested capital, less dispositions, write-downs and write-offs after the commitment period. These arrangements vary in accordance with the private fund's organizational documents.
    - The examination staff noted advisers who did not follow the practices described in fund disclosures for the calculation of the fund-level fee during the post-commitment period. Examples include advisers not reducing the costs basis of an investment after writing off, writing down or otherwise disposing a portion of the investment. In addition, advisers were noted who did not implement policies and procedures to ensure the consistent application of "impairments," "written down," etc. that resulted in inaccurate management fees being charged.
- Failure to comply with Limited Partnership Agreement (LPA) liquidation and fund extension terms.
    - The staff notes advisers who extended the terms of private funds without obtaining required approvals or complying with the liquidation provision set forth in the funds' LPA.
- Failure to invest in accordance with fund disclosures regarding the investment strategy.
- Failures relating to recycling practices.
    - Advisers did not adhere to the LPA key person process after the departure of adviser principals.

<u>Disclosures Regarding Performance and Marketing</u>
The staff observed advisers providing investors or prospective investors with misleading track records or other marketing statements that appear to violate Rule 206(4)-8. Following are noted examples of adviser materials that appear to violate Rule 206(4)-8.

- Misleading material information about a track record.
    - Advisers were observed who cherry-picked the track record of one fund or a subset of funds or did not disclose the material impact of leverage on fund performance. Also, advisers utilized stale performance information or track records that did not accurately reflect fees and expenses.
- Inaccurate performance calculations.
    - The staff noted advisers who used inaccurate underlying data in calculating performance. In addition, advisers provided projected performance rather than actual performance, thereby leading to the inclusion of inaccurate and misleading disclosures.
- Portability – failure to support adequately, or omissions of material information about,

predecessor performance.

- Advisers failed to maintain books and records supporting predecessor performance as required under Advisers Act Rule 204-2(a)(16). In addition, advisers marketed incomplete prior track records or advertised performance that people at the adviser were not primarily responsible for achieving at the prior firm.

- Misleading statements regarding awards or other claims.
    - The staff noted advisers who failed to make full disclosure about awards, such as the criteria for obtaining them, the amount of any fee paid by the adviser to receive them, and any amounts paid to the grantor for the adviser's right to promote receipt of the award. Also, advisers incorrectly claimed that their investments were "supported" or "overseen" by the SEC or the United States government.

Due Diligence

The examination staff observed failures to conduct a reasonable investigation into an investment, to follow the due diligence process described to clients or investors and to adopt and implement due diligence policies and procedures pursuant to Advisers Act Rule 206(4)-7. In addition, advisers failed to perform adequate due diligence on important service providers, such as alternative data providers and placement agents.

Hedge Clauses

A hedge clause is a statement or provision in an agreement that seeks to limit an adviser's liability. The staff observed advisers who included potentially misleading hedge clauses that purported to waive or limit the Advisers Act fiduciary duty, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud. Such clauses are inconsistent with Section 206 and 215(a) of the Advisers Act.

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Questions? Contact the DCS Team

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