SEC Continues Focus on Private Fund Adviser Disclosures and Other Topics

February 4, 2022

INTRODUCTION

On January 27, 2022, the Division of Examinations ("EXAMS") of the Securities and Exchange Commission (the "SEC") published a risk alert (the "Risk Alert") detailing certain compliance issues observed by EXAMS staff in their examinations of private fund advisers.

The Risk Alert focused on a number of private fund adviser compliance issues, some of which were recently discussed in Chair Gensler's November 10, 2021 speech[1] at the Institutional Limited Partners Association Summit. The Risk Alert indicated that these deficiencies reflect ongoing SEC staff concerns and new areas of focus.

IDENTIFIED DEFICIENCIES

The Risk Alert identified four categories of deficiencies: (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."

Conduct Inconsistent with Disclosures

The Risk Alert focused on the following sub-categories of conduct inconsistent with disclosures: (i) failure to obtain informed consent from LPACs, advisory boards or advisory committees, as required under fund disclosures, for issues involving conflicts or conflicted transactions; (ii) failure to follow practices described in fund disclosures regarding the calculation of post-commitment period fund-level management fees, specifically issues arising out of failures to properly account for changes in asset value due to asset sales, write-downs or impairments; (iii) failure to comply with limited

[1] Chair Gary Gensler, Prepared Remarks at the Institutional Limited Partners Association Summit (November 10, 2021); Comprehensive Capital Management, Inc. Release No. 5943 (Jan. 11, 2022) (the "ILPA Speech").

partnership agreement ("LPA") liquidation and fund extension terms by extending the fund terms without obtaining the required approvals or complying with the fund LPA liquidation provisions; (iv) failure to invest in accordance with fund disclosures regarding the fund's investment strategy; (v) failures related to recycling practices, such as not accurately describing the recycling practices or omitting related material information, that cause an adviser to collect excess management fees; and (vi) failure to follow fund disclosures regarding personnel by not adhering to the LPA "key person" process following the departure of adviser principals or not providing accurate information to investors regarding the status of previously employed key portfolio managers.

Disclosures Regarding Performance and Marketing

The Risk Alert's second category related to disclosures of private fund performance and marketing. The Risk Alert noted that Rule 204-2(a)(16) under the Investment Advisers Act of 1940 (the "Advisers Act") requires investment advisers to maintain all accounts, books and any other records or documents that are needed 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. Advisers Act Rule 206(4)-8 prohibits advisers to pooled investment vehicles from making false or misleading statements to, or defrauding, investors or prospective investors.

With respect to disclosures related to private fund performance and marketing, the Risk Alert highlighted the following issues: (i) fund advisers providing misleading material information about track records (e.g., only marketing a favorable or cherry-picked track record of one fund or a subset of funds); (ii) providing inaccurate performance calculations (*e.g.*, the creation of track records using data from incorrect time periods, mischaracterization of the return of capital distributions as portfolio company dividends and/or using projected rather than actual performance in performance calculations); (iii) failing to support adequately, or omitting material information about, predecessor performance; and (iv) fund advisers making misleading statements regarding awards or characteristics of their firm (e.g., failing to make full and fair disclosures about the awards, such as the criteria used in their selection for the award or any fees paid in order to receive the award or to permit the adviser to publish its receipt of the award).

Due Diligence

The Risk Alert's third category focused on due diligence of investments and service providers.

The Risk Alert highlighted private fund advisers that: (i) failed to conduct a reasonable investigation into investments (e.g., not performing adequate due diligence of the compliance or internal controls of underlying investments or private funds in which

they were potentially investing and not performing adequate due diligence of important service providers such as placement agents and alternative data providers) and (ii) had inadequate policies and procedures regarding the due diligence of investments (e.g., not maintaining policies or procedures related to due diligence that were tailored to their advisory business).

The Risk Alert noted that EXAMS staff also observed private fund advisers who failed to follow the due diligence policies and procedures that had been communicated to clients or investors.

Hedge Clauses

In the final category of deficiencies, the Risk Alert focused on the use of "hedge clauses." A "hedge clause" is defined in the Risk Alert as "a clause in an agreement, or a statement in disclosure documents provided to clients and investors, that purports to limit an adviser's liability." EXAMS staff noted instances of private fund advisers including in documents potentially misleading hedge clauses claiming to waiver or limit their Advisers Act fiduciary duty except for some limited exceptions, such as for gross negligence, willful misconduct or fraud.

Recently, the SEC has shown an increased interest in advisers potentially seeking to waive or limit their fiduciary obligations under the Advisers Act,[2] and the EXAMS staff's findings with respect to hedge clauses are consistent with the general narrative from the SEC that hedge clauses may be inconsistent with the Advisers Act. We note, however, that an indemnity in favor of a private fund adviser, a limited standard of care incorporated into an LPA or a hedge clause coupled with appropriate disclosure, do not operate as a waiver of the adviser's fiduciary obligations absent additional facts and circumstances.

Analysis

- The Risk Alert reflects a significantly greater deal of granularity than prior Risk Alerts concerning private funds, demonstrating the increased sophistication of the SEC and EXAMS staff in scrutinizing private fund advisers. For example, whereas prior Risk Alerts addressed the generic topic of management fee calculations and offsets, this Risk Alert addresses the distinction between pre- and post-commitment period fee calculations as well as the impact on fees from recycling practices and from the changes in the value of the portfolio as a result of write-downs and impairments.

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[2] *Supra* note 1, ILPA Speech.

- The wide-ranging deficiencies in the Risk Alert signal an aggressive and more granular review of private fund advisers' practices—a reality that will ultimately lead to enforcement investigations in these areas. Over the last year, Chair Gensler has signaled greater interest in private fund adviser enforcement and rulemaking,[3] and this Risk Alert is another shot across the bow.

- This Risk Alert puts sponsors on notice that the SEC staff is more than willing to intervene in the privately negotiated relationship between the private fund manager and the fund's limited partners. Although in the "legal background" section the staff putatively acknowledges the notion that "fiduciary duty must be viewed in the context of the agreed-upon scope" of the advisory relationship, the conduct highlighted by the Risk Alert reflects a strong staff bias in favor of second-guessing that arrangement.

- The Risk Alert reflects the staff's view that an overarching fiduciary duty reaches any conduct that the staff views as objectionable. For example, while it may be a best practice (or a practice required by a firm's policies and procedures) to adequately perform due diligence of service providers, it is not clear that, as a legal matter, the failure to do is a breach of an investment adviser's fiduciary duty. Indeed, the Risk Alert purports to be providing an overview of "compliance issues."

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Given the SEC's repeated focus on these compliance risk areas, private fund advisers should review the specific sub-categories and examples discussed above and consider whether, in light of their firm's particular practices, additional changes to their compliance policies and procedures are necessary.

Do not hesitate to contact us with any questions.

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[3] *Supra* note 1, ILPA Speech; *see* Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, Investment Advisers Act Release No. 5950 (Jan. 26, 2022) and *see* SEC Agency Rule List – Fall 2021(Dec. 13, 2021).

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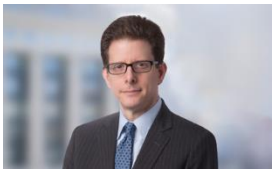

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