Insights

THE SEC'S RECENT OBSERVATIONS FROM EXAMINATIONS INTO PRIVATE FUND ADVISERS

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SUMMARY

- On January 27, 2022, the SEC released a Risk Alert from the Division of Examinations ("EXAMS"), wherein it reported concerns noted during its recent examinations of investment advisers who manage private funds ("private fund advisers"). A copy of the SEC's Risk Alert is linked HERE.
- This is the SEC's third Risk Alert in the last five (5) years regarding compliance issues in this space. Private fund advisers are likely to be a continued focus for the SEC.
- In the Risk Alert, EXAMS noted four problematic areas related to private fund advisers who 1) acted inconsistently with their obligations under fund disclosures, 2) made misleading marketing disclosures, 3) failed to perform appropriate due diligence before recommending investments, or 4) used hedge clauses to limit their liability for breaches of fiduciary duty.
- Below is a summary of the SEC's observations.

OVERVIEW

In the last five years, the SEC observed a 70% increase in the value of private fund assets. More than 5,000 SEC-registered advisers currently manage approximately $18 trillion in private fund assets, according to the Risk Alert. Because of the increases in AUM in private funds, as well as in the number of related advisers, the SEC has called for increased transparency, competition and efficiency in this market.[1]

On January 27, 2022, EXAMS released a summary of its findings from recent examinations into private fund advisers. EXAMS found shortcomings where advisers: 1) acted inconsistently with fund disclosures, 2) made misleading marketing disclosures, 3) did not conduct appropriate due diligence into fund offerings, or 4) used hedge clauses to limit their exposure for breaches of fiduciary duty.

This 2022 Risk Alert noted different issues than those observed in EXAMS's previous Risk Alerts related to private fund advisers in 2017 and 2020, linked in this sentence. The fact that EXAMS has repeatedly issued Risk Alerts on this topic, and that EXAMS finds different problematic issues in each Alert, suggests that EXAMS may continue examinations of private fund advisers until it sees improved compliance.

WHAT ARE "PRIVATE FUNDS" AND WHY IS THE SEC FOCUSING ON THEM?

"Private funds" are funds that do not solicit investments from the public or from retail investors. Only qualified and accredited investors, who are high net worth individuals with significant experience in the market, may invest in private funds. Because private fund investors are expected to be more sophisticated than ordinary investors, private funds are exempt from many reporting and recordkeeping requirements under the Investment Company Act of 1940. The most common types of private investment funds are hedge funds, private equity firms, venture capital funds and liquidity funds.

Private funds have become a focus for the SEC in part because of their growing role in the market. In the first three quarters of 2021, private equity buyouts grew by 133% to $818 billion.[2] More than a third of SEC registered investment advisers manage private fund assets, according to the SEC's recent Risk Alert. In spite of private funds' prominence in the market, the funds must make only limited reporting to the SEC on Form PF. In recent months, the SEC has shown signs that it wants more of a window into how such funds are managed. On January 26, 2022, the SEC voted to amend Form PF to require reporting to the SEC within one business day if the fund experiences certain serious adverse events, and to lower the threshold for filing Form PF from $2 billion to $1.5 billion in assets for private equity funds.[3] In addition, in early February 2022, the SEC voted to propose new rules that would make private funds more transparent to their own investors.[4] The revised rules may require annual audits to verify the valuation of a private fund's assets, limit undisclosed preferential treatment of certain investors, prevent funds from seeking reimbursement for SEC examination expenses, and bar funds from limiting their liability for breach of fiduciary duty through disclosures.[5] The SEC has not published any revised rules or a revised Form PF yet, and any such changes would have to go through a public comment period before becoming final.

The SEC's recent Risk Alert regarding private fund advisers should be read in the context of the SEC's expressed interest in making sure private fund investors are being treated fairly by fund managers.

FOUR PROBLEM AREAS FOR COMPLIANCE

Although investment advisers have lesser recordkeeping and reporting duties to their private fund investors than they would to retail clients, advisers are still expected to act in accordance with their fiduciary duties of care and loyalty under the Investment Advisers Act of 1940 (the "Advisers Act"). These duties require them to act in the "best interests" of their clients at all times. Likewise, private

fund advisers are expected to have sufficient written policies and procedures in place to prevent violations of the Advisers Act, and to review such documents at least annually. Finally, private fund advisers must act in accordance with the terms of their agreements with and disclosures to their customers. The Risk Alert noted problems with all of these areas of expected compliance.

Conduct that is inconsistent with disclosures

EXAMS noted a pattern of private fund advisers failing to act in accordance with practices required by the limited partnership agreements, operating agreements, private placement memoranda, due-diligence questionnaires, side letters and other disclosures (collectively, limited partnership agreements or "LPAs"). Several of these failures to abide by the terms of LPAs resulted in client harm through the charging of inaccurate management fees. Specifically, EXAMS noted that some advisers:

- Failed to appropriately consult the funds' Limited Partner Advisory Committees or other similar bodies (collectively, "LPACs") to secure the LPAC's consent to conflicts. Other advisers inappropriately waited to seek consent until after the conflicted transaction had already taken place, or brought incomplete information regarding the conflicts to the LPACs for their review.

- Failed to follow the procedures specified in LPAs for the calculation of fund-level management fees during the Post-Commitment Period. Some calculation errors failed to appropriately consider capital that had been disposed of, written down or written off during the capital commitment period.

- Extended private equity funds' terms without seeking the approval of the LPACs, potentially resulting in inappropriate management fees.

- Followed an investment strategy that differed, sometimes significantly, from the strategy specified in the fund disclosures, including exceeding leverage limitations.

- Did not follow "recycling" procedures specified in fund management documents, sometimes resulting in excess management fees.

- Did not keep investors updated when key portfolio managers left the organization.

Disclosures regarding performance and marketing

EXAMS also noted that some private fund advisers made misleading statements in their marketing materials in violation of Advisers Act Rule 206(4)-8. Others failed to keep the books and records necessary to support their calculation of rates of return and fund performance as required by Advisers Act Rule 204-2(a)(16). Advisers' marketing materials fell short where they:

- Misled investors regarding funds' track records. Advisers ran into trouble where they cherry-picked favorable outcomes from funds' history, failed to disclose information about the

material impact of leverage on fund performance, used stale performance data, or failed to accurately state fees and expenses.

- Inaccurately calculated funds' performance. Miscalculations took the form of mischaracterizing capital distributions as dividends, mislabeling projected performance as actual, or mislabeling time periods.
- Inaccurately described advisers' performance with predecessor firms. Advisers omitted material facts or advertised results that other individuals were primarily responsible for achieving.
- Made misleading statements regarding awards received. Some advisers failed to disclose that they had paid to receive awards or paid for the right to promote their receipt of the awards. Others inaccurately claimed that their investments were "supported" or "overseen" by the SEC.

Due diligence issues

The Risk Alert notes that an investment adviser's fiduciary duty requires the adviser to reasonably investigate investments before recommending them to a client. EXAMS noted advisers failed to discharge their due diligence duties when they:

- Failed to investigate the compliance and internal controls of the private funds in which they invest.
- Failed to perform due diligence on key service providers, such as placement agents and alternative data providers.

Failed to maintain policies and procedures related to due diligence investigation of investments that are tailored to the adviser's business.

Problems with hedge clauses

A "hedge clause" is a statement in an agreement or disclosure that attempts to limit an adviser's liability. EXAMS frowned upon hedge clauses that purported to completely insulate advisers from liability for breaches of fiduciary duty, or to limit their liability to situations in which there is a non-appealable judicial finding of gross negligence, willful misconduct or fraud. EXAMS found such clauses misleading and potential violations of Section 206 and 215(a) of the Advisers Act.

CONCLUSION

As the amount of AUM in private funds, such as hedge funds, private equity firms and venture capital funds, has exploded in recent years, the SEC is paying greater attention to these funds. While the investors in private funds are presumed to be sophisticated, and such funds bear lesser reporting burdens than retail investments, advisers who manage private funds must still take care

to act in the best interest of such investors. Likewise, private funds advisers should review and maintain their policies and procedures, especially in relation to fee calculations. They should ensure that their marketing materials are up to date and make only claims that the adviser can support with documentation. Finally, advisers should be careful to perform appropriate due diligence before recommending private funds and should avoid the use of hedge clauses in client-facing materials.

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[1] SEC Press Release, "SEC Proposes to Enhance Private Fund Investor Protection" (Feb. 9, 2022).

[2] Katanga Johnson, Yahoo! Finance, "Private fund advisers to spell out fees, performance under new U.S. SEC proposals" (Feb. 9, 2022).

[3] SEC Press Release, "SEC Proposes Amendments to Enhance Private Fund Reporting" (Jan. 26, 2022).

[4] SEC Press Release, "SEC Proposes to Enhance Private Fund Investor Protection" (Feb. 9, 2022).

[5] *Id.*; Katanga Johnson, Yahoo! Finance, "Private fund advisers to spell out fees, performance under new U.S. SEC proposals" (Feb. 9, 2022); Bob Pisani, CNBC, "SEC Chair Gary Gensler wants to know more about what hedge funds and private equity are doing" (Feb. 9, 2022).

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