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SEC Identifies Private Fund Deficiencies, Signifying Increased Industry Scrutiny

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On the heels of the SEC's proposed rulemaking seeking increased disclosure from private fund advisers in Form PF,[1] the SEC's Division of Examinations ("Exam Staff") released a risk alert on Jan. 27, 2022 ("Risk Alert"),[2] highlighting common deficiencies identified during its examinations of private fund advisers.[3] In the Risk Alert, the staff pointed out that there has been a significant increase in private fund assets under management over the last five years. This has also been a theme in recent speeches by Chair Gary Gensler and the SEC's Director of the Enforcement Division, Gurbir Grewal, making clear that under the stewardship of Chair Gensler, the SEC and its staff will be focused on the activities of private fund advisers in the near term. The findings in the Risk Alert are consistent with what we have observed on examination of private fund advisers.

Four types of deficiencies are detailed in the Risk Alert: (1) failure to act consistent with disclosures, (2) use of misleading marketing materials, (3) failure to conduct adequate diligence of investments and service providers (including alternative data providers) and (4) the use of overly broad "hedge clauses."

Many of the deficiencies described in the Risk Alert could have been avoided with more careful attention to the interplay between the manager's operations, disclosures and policies. A review of marketing practices is also warranted, not only in light of the Risk Alert, but also because of the upcoming advertising rule change.

More broadly, private fund managers should carefully evaluate whether their practices are consistent with the positions described in the Risk Alert. Compliance professionals should also incorporate these points into the next annual compliance review and be prepared to address them with the Exam Staff in future examinations.

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[1] "SEC Proposes Substantial Increases to Form PF Reporting," *SRZ Alert*, Jan. 26, 2022, available here.

[2] "Observations from Examinations of Private Fund Advisers," *Division of Examinations Risk Alert*, Jan. 27, 2022, available here.

[3] The Risk Alert follows a June 2020 risk alert that addressed common exam deficiencies related to conflicts of interest, MNPI and Code of Ethics violations and fees and expenses, available here.

Practices Inconsistent with Disclosures

It has been nearly ten years since many private fund advisers were first required to register with the SEC. The Exam Staff now has extensive experience conducting examinations of private fund advisers. Its observations regarding disclosures reflect the evolution of the Exam Staff's facility with private fund structure, terms and investment strategies. These observations also demonstrate that legal and compliance cannot be siloed – that is cannot be separate from the business at large. Instead, they must be involved sufficiently in the key business developments and transactions of the firm to seek to ensure they are conducted consistent with the relevant disclosures and the firm's policies and procedures. In particular, a critical review of the operations, disclosures and policies relating to fee calculations, investment mandates, consent mechanics and other key points of potential friction within a fiduciary relationship should be undertaken.

- *LPAC Consent.* The Exam Staff noted instances where advisers did not seek consent from advisory boards or limited partner advisory committees (together, "LPACs") pursuant to disclosure provided in offering documents, due diligence questionnaires and other disclosure documents. Specifically, the Exam Staff identified conflicted transactions as an area where some private fund advisers did not engage with LPACs. Firms should have processes to both identify conduct that may require LPAC consent (as per fund disclosures or other requirements like principal transaction approval) and also make an informed decision as to whether consent is required and, if so, in what form.
- *Management Fee Calculation.* The Risk Alert identifies inadequacies (i) in the calculation of post-commitment period fund-level management fees, particularly where advisers did not adjust the value of an investment "after selling, writing off, writing down or otherwise disposing of a portion of an investment" and (ii) where disclosures used undefined terms regarding investments that had been impaired or written down without sufficient policies and procedures addressing how such terms should be understood with respect to fee calculations.
- *Liquidation and Extension Provisions.* The Exam Staff found that advisers extended fund lifetimes without obtaining approval as required in fund organizational documents, which caused advisers to earn management fees they may not have otherwise. The Exam Staff has in the past focused on so-called "zombie funds," which are viewed as being extended far beyond their contemplated life so that advisers can charge additional fees.
- *Investment Strategy.* The Risk Alert identifies that certain private fund advisers employed materially different investment strategies and exceeded limits on leverage as compared to what was disclosed in fund documents. Advisers to liquid strategies seeking to increase client exposure to private investments should be mindful of that exposure not only in light of their investment mandate but also in light of their redemption mechanics.
- Private fund advisers were found to have inaccurately disclosed or omitted material information in their disclosures with respect to reinvestment of realized investment gains, which, in some instances, led to private fund investors incurring excess management fees.
- *Key Person Provisions.* The Exam Staff also noted that certain private fund advisers did not adhere to key person provisions in their fund organizational documents, including not providing appropriate disclosure to investors regarding the departure of key investment professionals.

Performance and Marketing Disclosures

The calculation and display of performance information has consistently been the Exam Staff's focus when assessing marketing materials; the findings in the Risk Alert are no exception. Private fund advisers should expect scrutiny whenever they are displaying hypothetical, predecessor or individual investment performance. Additionally, these findings serve as a precursor to the focus on advertising materials that is likely to come after the November 2022 compliance date for the SEC's new marketing rule.

- *Track Records.* The Exam Staff identified that many advisers did not accurately present performance track records. The Exam Staff found that many advisers cherry-picked certain fund performance, did not disclose the impact of leverage on returns and used performance that did not reflect the deduction of fees and expenses.
- *Performance Calculations.* Many private fund advisers were identified as having inaccurately calculated performance returns, by, among other things, calculating the performance over the wrong time period, mischaracterizing the return of capital from portfolio companies and incorporating projected rather than actual performance.
- *Predecessor Performance.* The Risk Alert identifies that many advisers did not maintain the books and records underlying performance as required under Rule 204-2 and utilized track records in marketing materials for which advisory personnel were not primarily responsible. In our experience, the Exam Staff has been very focused on the portability of track records. Private fund advisers must be able to demonstrate that their use of predecessor performance comports with the applicable guidance (and the new marketing rule as of its compliance date in November).
- Many advisers were also identified as having made misleading statements regarding awards they had received, and had not included requisite disclosure regarding the criteria for obtaining the awards and fees paid in connection with receiving or marketing receipt of the award.

Investment Diligence

The Exam Staff expressed concern that private fund advisers were not meeting their fiduciary duty, in part, because they did not have a reasonable belief that investment advice was in the best interest of their clients as supported by a reasonable investigation into investment opportunities pursued. In the Risk Alert, the Exam Staff identified that certain private fund advisers did not conduct sufficient diligence on investments or employ policies and procedures designed to ensure appropriate diligence was conducted.

The research and investment process at private fund advisers is dynamic and multi-faceted, and there is no uniform approach to recordkeeping when it comes to investment diligence. Different investment strategies entail very different types of diligence. However, it is typical that Exam Staff will request during an examination that advisers provide research files with respect to their investments. An inability to demonstrate that an adviser's investment decisions are based on reasonable diligence can lead to the types of deficiencies identified by the Exam Staff and can create concern among the Exam Staff that investment decisions are being made on a basis other than sound diligence (i.e., material non-public information).

The Risk Alert also highlights the importance of diligence of service providers, specifically noting alternative data providers and placement agents. The proliferation of alternative data and its increasing importance in the investment process create diligence challenges for advisers. The Exam Staff has been working on a risk alert with respect to alternative data, but, in the meantime we see increased scrutiny during examinations of advisers' use of such data.

Hedge Clauses

In the Risk Alert, the Exam Staff identified that certain advisers included in client agreements potentially misleading provisions that sought to waive the fiduciary duty except for certain exceptions, "such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud." The Risk Alert notes that whether such a clause violates the antifraud provisions of the Advisers Act will depend on all of the surrounding facts and circumstances. The Exam Staff cites the 2019 Commission Interpretation Regarding the Standard of Conduct for Investment Advisers, which indicated that although "blanket" waivers of fiduciary duties are impermissible, fiduciary duties must be viewed in the agreed-upon context of the particular client and adviser.