SEC Staff Observes Practices of Private Fund Advisers That Raise Concerns

February 11, 2022

Investment advisers that manage private funds should promptly review their compliance policies and procedures, practices and disclosures to ensure these address, and are not inconsistent with, the areas of concern raised in a recent Risk Alert (Risk Alert) issued by the Securities and Exchange Commission's (SEC) Division of Examinations (EXAMS).

Issued on January 27, the areas of concern highlighted by EXAMS in the Risk Alert indicate that, in many cases, private funds' advisers are:

- not acting consistently with disclosures;
- using misleading disclosures regarding performance and marketing;
- failing to conduct adequate due diligence elating to investments and service providers; and
- using potentially misleading "hedge clauses."

Since the beginning of February 2022, there has been a flurry of warnings and rule proposals from the SEC focusing on private funds and investment advisers to private funds. This Katten advisory focuses solely on the Risk Alert dealing with compliance issues observed by the SEC Staff in examinations of registered investment advisers that manage private funds. Watch for us to share summaries of these other warnings and rule proposals in the near future.

The Risk Alert follows SEC Chair Gary Gensler's November 10, 2021 speech at the Institutional Limited Partners Association Summit where he warned that it was time to "bring more sunshine and competition to the private funds space." (Chairman Gensler's speech is available here.)

In case there was any doubt, the message from the SEC under Chairman Gensler is clear — private funds (including hedge funds and private equity funds) and investment advisers to these funds should take prompt action to address the areas of concern raised in the Risk Alert.

Background. The Risk Alert provides the legal background on an investment adviser's fiduciary duty and reminds firms that an investment adviser "must, at all times, serve the best interest of its client and not subordinate its client's interest to its own. In other words, the investment adviser cannot place its own interests ahead of the interests of its client. This combination of care and loyalty obligations requires the investment adviser to act in the "best interest" of its client at all times."

Conduct Inconsistent With Disclosures. In the Risk Alert, EXAMS highlighted the following failures to act consistently in accordance with material disclosures to clients and investors:

- **Lack of Informed Consent.** EXAMS observed that private fund advisers did not consistently follow practices described in their limited partnership agreements (LPAs), operating agreements, PPMs , due-diligence questionnaires, side letters or other disclosures regarding the use of the fund's limited partner advisory committee (or similar body). This included not bringing conflicts to advisory committees for the necessary review and consent.
- **Improper Fee Calculations.** EXAMS noted that private fund advisers failed to always calculate fees in accordance with fund documents, focusing on the calculation of fund-level management fees during a private fund's Post-Commitment Period. The Risk Alert points to private fund advisers not reducing the cost basis of an investment when calculating their management fee after selling, writing off, writing down or otherwise disposing of a portion of an investment. The Risk Alert also pointed to private fund advisers that "used broad, undefined terms in the LPA, such as "impaired," "permanently impaired," "written down," or "permanently written down," but did not implement policies and procedures reasonably designed to apply these terms consistently when calculating management fees, potentially resulting in inaccurate management fees being charged." Improperly calculated fees has been a consistent focus of the SEC for many years.
- **Not Complying With LPA Liquidation and Fund Extension Terms.** EXAMS observed advisers that extended the terms of private equity funds without obtaining required approvals or without complying with the LPA's liquidation provisions. This could result in potentially inappropriate management fees being charged to investors.
- **Not Investing in Accordance With Disclosed Investment Strategy or Providing Information About "Key Persons."** The SEC staff indicated that private fund advisers did not uniformly comply with a fund's stated investment limitations, noting, among other things, advisers that exceeded limits on a fund's use of leverage. EXAMS also observed that advisers did not follow the LPA's "key person" process or provide investors with accurate information regarding the departure of principals of the adviser and portfolio managers.
- **Disclosures Regarding Performance and Marketing.** EXAMS observed private fund advisers sometimes using misleading track records in violation of the antifraud provisions of the Investment Advisers Act of 1940 (Advisers Act), as well as advisers not maintaining required books and records. These areas will likely be subject to increased scrutiny by the SEC with the pending effective date of the new marketing rule under the Advisers Act coming in November 2022. Observations of the Staff included:
  - **Misleading Track Records.** EXAMS staff found that investment advisers managing private funds sometimes used inaccurate or misleading disclosures about track records, including how benchmarks were used or how the portfolio for the track record was constructed. The staff noted examples of advisers using stale performance, marketing only favorable or cherry-picked performance and track records of one fund or a subset of funds and not disclosing material information about the material impact of leverage on fund performance.
  - **Inaccurate Performance Calculations.** The staff observed private fund advisers presenting inaccurate performance calculations to investors, including using inaccurate underlying data (e.g., data from incorrect time periods, mischaracterization of return of capital distributions as dividends from portfolio companies, and/or projected rather than actual performance used in performance calculations) when creating track records.
  - **Portability – Failure to Support Adequately, or Omissions of Material Information About, Predecessor Performance.** EXAMS identified that investment advisers managing private funds sometimes failed to maintain books and records supporting predecessor performance at other advisers, as required under the Advisers Act, and that private fund advisers appeared to omit certain material facts about predecessor performance, like advertising performance that persons at the adviser were not primarily responsible for achieving at the prior adviser.

Due Diligence. As noted above, the Risk Alert emphasized the fiduciary duty owed by private fund advisers to the private funds they manage. This includes an obligation of the adviser to conduct due diligence (i.e., a reasonable investigation) so the adviser has a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives and to ensure that the adviser is not basing its advice on materially inaccurate or incomplete information. EXAMS observed investment advisers that failed to conduct reasonable investigations of investments in accordance with the adviser's policies and procedures, including the compliance and internal controls of the underlying investments or private funds in which they invested. The staff also indicated there were advisers that failed to perform adequate due diligence on important service providers, including alternative data providers and placement agents.

Hedge Clauses. A hedge clause is a provision in an investment advisory agreement or other agreement that limits an adviser's liability to its client. EXAMS observed that private fund advisers included "potentially misleading hedge clauses in documents that purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud" and noted that these clauses could be inconsistent with the Advisers Act.

Conclusion

Investment advisers managing private funds should carefully review the Risk Alert and assess their compliance policies and procedures, practices and disclosures focusing on the issues raised in the Risk Alert. The Risk Alert is available here.

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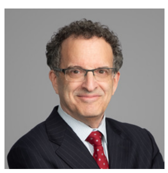

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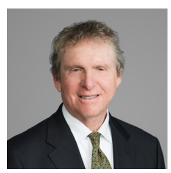

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