Risk Alert: Observations from Examinations of Private Fund Advisors

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Introduction

SEC-registered investment advisors (“Advisors”) manage approximately $18 trillion in private fund assets, an increase of 70% just in the past five years. Private fund managers vary widely in investment strategies (i.e. hedge funds, private equity funds, real estate funds, venture capital funds), assets under management (“AUM”), and the size and complexity of the private funds’ Advisors.

In consideration of the significant and growing role of Advisors to private funds, the SEC Division of Examinations (the “SEC”) has conducted significant numbers of examinations and issued multiple Risk Alerts regarding its findings, including the most recent issued on January 27, 2022.

Specifically, in the current Risk Alert, the SEC highlighted the following violations: (A) failure to act consistently with fund disclosures; (B) use of misleading disclosures regarding performance and marketing; (C) due diligence failures relating to investments and/or service providers; and (D) use of misleading “hedge clauses.”

Private Fund Advisor Deficiencies

A. Failure to Act Consistently with Disclosures

- Limited Partner Advisory Boards and Committees (“LPACs”) – The SEC observed that Advisors did not follow practices described in limited partnership agreements (“LPAs”), operating agreements, private placement memoranda, due-diligence questionnaires, side letters, and other disclosures (“fund disclosures”) regarding the use of LPACs. For example, certain Advisors failed to receive informed consent from the LPACs regarding conflicted transactions as required in the fund disclosures.
- Post-Commitment Period Management Fees – The SEC noted that certain Advisors did not follow the fee calculation practices as described in the fund disclosures, leading to investors paying higher management fees than necessary. For example, Advisors did not revalue investments for purposes of fee calculations after sales, write-offs, or partial liquidations of certain investments.
- LPA Liquidation and Extension Terms – Advisors extended the terms of private equity funds without complying with the liquidation provisions described in the funds’ LPAs and/or without receiving the proper approvals which resulted in inappropriate management fees.
- Investment Strategy – Advisors were found to not comply with the investment and/or leverage limitations in fund disclosures and/or implemented investment strategies that were materially different than as described in fund disclosures.
- Recycling – “Recycling” refers to contractual provisions that allow a private fund to add realized investment proceeds back to the capital commitments of investors. Certain Advisors did not accurately describe or omitted material information regarding their funds’ recycling practices. Excess management fees were collected from investors in certain cases.
- Advisor Personnel – Funds often have provisions in their fund disclosures discussing key personnel. Certain Advisors were observed to be out of compliance with those provisions, including not informing investors of the departures of key principals and/or portfolio managers, as required.

B. Disclosures Regarding Performance and Marketing

- Misleading Material Information Regarding Track Record – Various violations of SEC marketing regulations were noted, including the use of inappropriate benchmarks, failing to properly document track record construction, cherry-picking the performance of certain funds, failing to state the effect of leverage on fund performance, and showing performance on a gross of fees basis only.
- Inaccurate Performance Calculations – The SEC found numerous instances of Advisors using inaccurate performance results in marketing materials as a result of using inaccurate underlying data, incorrect time periods,

mischaracterization of return of capital distributions as dividends, and/or using projected rather than actual performance. Such inaccurate performance calculations led to misleading disclosures.

- Portability – Portability of performance involves using performance from a previous fund for a current fund. The SEC observed certain Advisors failing to maintain the required books and records regarding performance at predecessor funds, marketing incomplete track records, and failing to disclose that certain personnel were not responsible for the track record of the predecessor fund.
- Misleading Statements Regarding Awards or Other Claims – Advisors were found to market the receipt of certain awards without disclosing the criteria for the awards and whether the Advisor paid any fees to receive the award or if payments were made to the grantor of the award so that the Advisor could advertise its receipt of the award. The SEC also observed instances of Advisors claiming that they were “supported” or “overseen” by the US Government.

C. Due Diligence

As a fiduciary, Advisors are required to have a reasonable belief that the advice provided, and the investments made, are in the clients’ best interests. Advisors must have adequate policies and procedures regarding conducting due diligence on potential investments in order to have a reasonable basis to conclude that such investments meet clients’ investment objectives.

The SEC observed that certain Advisors failed to perform a reasonable inquiry into the underlying investments in their funds and failed to comply with their policies and procedures in this regard. Advisors were also observed to have failed to perform reasonable due diligence on key service providers, including data providers and placement agents.

Further, Advisors were found to have inadequate policies and procedures regarding investment due diligence. For example, certain Advisors described due diligence procedures in fund disclosures but did not maintain actual policies and procedures that were tailored to their advisory businesses.

D. Hedge Clauses

A statement limiting an Advisor’s liability is a “hedge clause.” Depending on surrounding facts and circumstances, hedge clauses may be misleading and make violate the Advisers Act. The SEC found that certain Advisors attempted to limit liability unless found to be grossly negligent or guilty of willful misconduct or fraud.

Conclusion

The SEC remains focused on Advisors to private funds as AUM continues to climb. SEC examinations have led to deficiency letters and referrals to SEC Enforcement. Advisors should review all fund documents including LPAs and fund disclosures to ensure that they are meeting the obligations therein. Marketing materials should be reviewed for compliance with relevant Advisors

Act requirements. Finally, Advisors should review their policies and procedures regarding due diligence and avoid the use of hedge clauses.