

MEMO# 34024

February 4, 2022

SEC Division of Examinations Publishes Risk Alert on Private Fund Advisers

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TO: ICI Members

Chief Compliance Officer Committee

Compliance Advisory Committee

Investment Advisers Committee

SEC Rules Committee SUBJECTS: Compliance

Investment Advisers RE: SEC Division of Examinations Publishes Risk Alert on Private Fund Advisers

On January 27, the SEC's Division of Examinations ("EXAMS") issued a Risk Alert on private fund adviser compliance deficiencies.^[1] The alert compiles results from past exams as seen through the lens of advisers' fiduciary duties and requirements under the Advisers Act prohibiting untrue statements of material facts^[2] and establishing compliance programs.^[3] With this background in mind, the EXAMS staff observed four areas of deficiencies:

- Failure to act consistently with fund disclosures;
- Use of misleading disclosures regarding performance and marketing;
- Due diligence failures relating to investments or service providers; and
- Use of potentially misleading hedge clauses. ^[4]

This Risk Alert builds on a 2020 Risk Alert that also addressed private fund adviser compliance issues. That alert found deficiencies related to conflicts of interest, fees and expenses, and policies and procedures relating to material non-public information.^[5]

Observed Deficiencies

Conduct Inconsistent with Disclosures

Deficiencies in this area include:

- Failure to obtain informed consent from Limited Partner Advisory Committees, Advisory Boards, or Advisory Committees, as required under fund documents.
- Failure to follow practices described in fund disclosures regarding the calculation of Post-Commitment Period fund-level management fees.
- Failure to comply with liquidation and fund extension terms.

- Failure to invest in accordance with fund disclosures regarding investment strategy.
- Failures to accurately describe recycling practices in disclosures, including by omitting material information about recycling practices from disclosures.
- Failure to follow key person processes in disclosures regarding adviser personnel.

Misleading Disclosures Regarding Marketing and Performance

The findings in this area include:[\[6\]](#)

- Misleading material information about an adviser's track record, including cases where an adviser only disclosed favorable track records or used stale track record information.
- Inaccurate performance calculations, including the use of incorrect time periods or projected performance rather than actual performance.
- Portability - failure to support adequately, or omissions of material information about, predecessor performance.
- Misleading statements regarding awards or other claims, including omissions about the criteria for obtaining an award or fees paid to receive an award.

Investment and Service Provider Due Diligence Failures

The findings in this area include:

- Lack of a reasonable investigation into underlying investments or funds.
- Inadequate policies and procedures regarding investment due diligence.

Use of Potentially Misleading Hedge Clauses

The EXAMS staff discusses potentially misleading hedge clauses that were drafted to waive or limit fiduciary duty, with exceptions for gross negligence, willful misconduct, or fraud. The staff notes that the use of hedge clauses in agreements or disclosure documents could constitute violations of Advisers Act Sections 206(1), 206(2), or 215(a), depending on facts and circumstances.

Conclusion

Examinations of private fund advisers have resulted in actions ranging from deficiency letters to referrals to the Enforcement Division. The EXAMS staff encourages private fund advisers to review their practices and ensure that advisers have written policies and procedures to address the issues discussed in this Risk Alert.

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endnotes

[\[1\]](#) See Observations from Examinations of Private Fund Advisers, Division of Examinations Risk Alert (Jan. 27, 2022), available at

<https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf>.

[2] Advisers Act Rule 206(4)-8.

[3] Advisers Act Rule 206(4)-7.

[4] Hedge clauses are clauses in agreements or disclosure documents that attempt to limit an adviser's liability.

[5] See Observations from Examinations of Investment Advisors Managing Private Funds, Division of Examinations Risk Alert (June 23, 2020), available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

[6] The staff notes that the Commission adopted significant revisions to Advisers Act Rule 206(4)-1 regarding private fund marketing. The rule, which advisers must comply with by November 4, 2022, provides additional specificity regarding misleading marketing materials.

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