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CLIENT MEMORANDUM

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SEC Highlights Deficiencies Observed in Examinations of Private Fund Advisers

On January 27, 2022, the SEC's Division of Examinations ("EXAMS") published a Risk Alert[1] highlighting the following areas of deficiencies observed by EXAMS staff in their examinations of investment advisers to private equity funds and hedge funds: (i) failure to act consistent with disclosures; (ii) use of misleading disclosures regarding performance and marketing; (iii) due diligence failures relating to investments or service providers; and (iv) use of potentially misleading "hedge clauses."

Read together with SEC Chair Gary Gensler's recent request to SEC staff to recommend rulemakings for private funds[2] with respect to, among other things, fees and expenses, performance metrics, side letters and conflicts of interest, as well as the recently proposed amendments to Form PF,[3] this Risk Alert demonstrates the SEC's intent to increase its regulation of the private funds industry. As the SEC's focus on private funds intensifies, private fund advisers may wish to review the accuracy of disclosures made to investors, their practices and operations, written policies and procedures, and implementation of those policies and procedures, including proper testing.

Conduct Inconsistent with Disclosures

EXAMS staff observed conduct by private fund advisers inconsistent with fund disclosures in the following areas:

- **LPAC Consent** – Failure to bring conflicts of interest to the fund's Limited Partner Advisory Committee ("LPAC") for review and consent; failure to obtain informed consent from the LPAC (*e.g.*, obtaining LPAC consent based on incomplete information); and failure to obtain LPAC consent prior to certain conflicted transactions, in each case, in contravention of the fund's limited partnership agreement ("LPA"), private placement memorandum, due-diligence questionnaires, side letters or other disclosures (collectively, "disclosures").

- **Post-Commitment Period Management Fees** – Failure to follow practices described in a private equity fund's disclosures regarding the calculation of management fees after the end of the fund's commitment period resulting in investors ("LPs") paying excess management fees (*e.g.*, failure to reduce the cost basis of an investment when calculating the management fee after selling, writing off, writing down or otherwise disposing of a portion of an investment; the use of broad, undefined terms in the LPA, such as "impaired," "permanently impaired," "written down" or "permanently written down," without implementing policies and procedures reasonably designed to apply these terms consistently when calculating management fees).

- **Term Extensions** – Failure to obtain the requisite consent by LPs or the LPAC to extend the term of a private equity fund or failure to comply with the liquidation provisions described in the fund's LPA, which, among other things, resulted in excess management fees being charged to LPs.

- **Investment Limitations** – Failure to invest in accordance with the fund's disclosures regarding investment strategy, including exceeding investment and leverage limitations.

- **Recycling** – Failure to accurately describe the recycling practices (*i.e.*, adding realized investment proceeds back to an LP's unfunded commitment to a fund) utilized by a fund, which resulted in excess management fees being charged to LPs.

- **Key Person Events** – Failure to follow the LPA's key person process(es) or inform LPs after the departure of relevant adviser personnel.

Misleading Disclosures Regarding Performance and Marketing

EXAMS staff observed inaccurate disclosures by private fund advisers regarding performance and marketing in the following areas:

- **Track Record** – Inaccurate or misleading disclosures about the adviser's track record, including how benchmarks were used or how the portfolio for the track record was constructed (*e.g.*, cherry-picking; failure to disclose material information about the material impact of leverage on fund performance; use of stale performance information; failure to accurately reflect fees and expenses).

- **Performance Calculations** – Inaccurate performance calculations presented to LPs; use of 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 of Performance** – Failure to maintain books and records supporting predecessor performance at other advisers; omissions of material facts about predecessor performance (*e.g.,* marketing incomplete prior track records or advertising performance that persons at the adviser were not primarily responsible for achieving at the prior adviser).

- **Awards** – Misleading statements regarding awards the adviser received (*e.g.*, marketing awards received without full and fair disclosures about the criteria for obtaining them, the amount of any fee paid by the adviser to receive them, and any amounts paid to the grantor of the awards for the adviser's right to promote its receipt of the awards).

- **Misleading Claims** – Misleading claims that the adviser's investments were "supported" or "overseen" by the SEC or the United States government.

Due Diligence Failures

EXAMS staff observed inadequate due diligence by private fund advisers in the following areas:

- **Investments; Service Providers** – Failure to perform 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; failure to perform adequate due diligence on key service providers (*e.g.*, placement agents).

- **Policies and Procedures** – Failure to maintain reasonably designed policies and procedures regarding due diligence of investments.

Use of Hedge Clauses

EXAMS staff observed misleading "hedge clauses" in fund LPAs and other fund disclosures purporting to limit the adviser's liability (*e.g.*, hedge clauses purporting to waive or limit the adviser's fiduciary duty under the Advisers Act except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct or fraud).[4]

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[1] See SEC Division of Examinations Risk Alert: Observations from Examinations of Private Fund Advisers.

[2] See SEC Chair Gary Gensler's Prepared Remarks at the Institutional Limited Partners Association Summit.

[3] See Proposing Release: Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers.

[4] As a reminder, an investment adviser's fiduciary duty under the Investment Advisers Act of 1940 ("Advisers Act") comprises a duty of care and a duty of loyalty. This means the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own. Although investment advisers owe their clients a fiduciary duty under the Advisers Act, that fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client. Whether a hedge clause is misleading and would violate Sections 206(1) and 206(2) of the Advisers Act depends on all of the surrounding facts and circumstances. See Commission Interpretation Regarding Standard of Conduct for Investment Advisers.