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SEC Risk Alert Details Additional Private Fund Adviser Examination Deficiencies

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On January 27, 2022, the U.S. Securities and Exchange Commission's (the "SEC") Division of Examinations ("Exams") issued a risk alert (the "2022 Risk Alert") identifying compliance issues observed by Exams staff (the "Staff") in examinations of registered investment advisers that advise private funds.

The 2022 Risk Alert indicates that it builds on an earlier risk alert ("2020 Risk Alert") issued by Exams that addressed deficiencies commonly identified by the Staff in examinations of private fund advisers, and was issued due to the "significant role of private fund advisers in the financial markets" and the "substantial growth in reported private fund assets." As summarized here, the 2020 Risk Alert cited deficiencies that fell into the following general categories:

- Conflicts of interest;
- Fees and expenses; and
- Policies and procedures relating to material nonpublic information.

The 2022 Risk Alert expands the list of deficiencies purportedly commonly observed in examinations of private fund advisers, to include the following additional categories:

- Conduct inconsistent with disclosures to private fund investors or fund terms;
- Performance and marketing deficiencies;
- Investment due diligence deficiencies; and
- Use of hedge clauses in fund-related documents.

The 2022 Risk Alert was published shortly before the SEC is expected to propose new rules tightening the regulation of private fund advisers and providing new disclosure

requirements.[1] It was also issued just after the SEC proposed new amendments to Form PF that would materially increase reporting requirements for private fund advisers, particularly as it relates to areas of interest to the SEC and the Staff, such as GP-led secondary transactions. These developments show a significantly tightening SEC regulatory climate for private fund registered advisers.

Conduct Inconsistent With Disclosures

The 2022 Risk Alert identifies the following specific practices that the Staff observes were not adequately disclosed to private fund investors, or which were inconsistent with fund governing documents:

Obtaining Informed LPAC Consent

- *Risk area:* The failure of private fund advisers to obtain the informed consent of a private fund's limited partner advisory committee or similar body ("LPAC") as required under fund governing documents by: (i) failing to bring a conflict to the LPAC for review and consent; (ii) obtaining consent for conflicted transactions after the transaction occurred; or (iii) obtaining consent to a conflicted transaction based on incomplete information.
- *Kirkland observations:* The Staff regularly scrutinizes whether private fund advisers have obtained consent to conflicts or conflicted transactions, as required by applicable law (e.g., principal transactions), contractual provisions in a fund's governing documents (e.g., in a fund's limited partnership agreement ("LPA"), side letters or operating agreements) or disclosure to investors regarding the use of LPACs (e.g., in a fund's private placement memorandum ("PPM"), due diligence questionnaires or other disclosures). In addition to focusing on whether LPAC consent is properly sought, the Staff frequently focuses on whether the information provided to the LPAC is sufficient to allow the LPAC to provide informed consent to the conflict.

Management Fee Calculations

- *Risk area:* When calculating management fees after a fund's investment period has ended, the failure of a private fund adviser to calculate fees in accordance with fund documents, or the failure of a private fund adviser to implement policies and

procedures for consistent calculation of management fees where the terms of fund governing documents were ambiguous around the impact of portfolio company dispositions, write-downs, write-offs and impairments on such calculations.
- *Kirkland observations:* The Staff has long focused on whether private fund advisers are correctly calculating management fees. We have observed a growing interest by the Staff as to whether private fund advisers are following practices specified in fund governing documents for management fee calculations as it relates to investments that have been partially realized, written down, written off or otherwise impaired. In particular, the Staff has focused on evaluating whether partial realizations, portfolio company restructurings or other instances of distress at a portfolio company resulted in a reduction in the basis for calculating management fees under the fund's governing documents. While we have seen a limited number of recent actual deficiencies in this area, in our experience this has not been a common deficiency among private fund advisers.

Liquidation and Fund Extension Terms

- *Risk area:* The failure of a private fund adviser to comply with the specific provisions of the LPA, including required approvals, when liquidating a private equity fund or extending its term.
- *Kirkland observations:* The Staff expects private fund advisers to adhere to LPA requirements and general fiduciary duties under the Investment Advisers Act of 1940, as amended ("Advisers Act"), related to fund liquidations and fund term extensions. Fund extensions generally require specific investor or LPAC approval requirements as set forth in the fund's governing documents. The Staff's focus in these situations is both consistency with provisions in fund governing documents and disclosures, as well as validating that any collateral impacts on management fee calculations were appropriately addressed. While we have seen a limited number of recent actual deficiencies in this area, in our experience this has not been a common deficiency among private fund advisers.

Investing Practices — Consistency with Disclosures re: Investment Strategy

- *Risk area:* The failure of a private fund adviser to comply with applicable investment limitations specified in fund disclosures, such as implementing an investment strategy that diverges materially from fund disclosures, or exceeding leverage limitations detailed in fund disclosures.

- *Kirkland observations:* The Staff will typically look at the descriptions of a fund's investment strategy in its PPM, as well as the applicable investment limitations described in its PPM and other governing documents, to assess whether an adviser is implementing, in all material respects, the disclosed investment strategy and has complied with specified limitations (particularly as it relates to concentration and leverage limits, which could significantly impact portfolio risk, or trigger LPAC consent requirements). While we have seen a limited number of recent actual deficiencies in this area, in our experience this has not been a common deficiency among private fund advisers.

Recycling Practices

- *Risk area:* The failure of a private fund adviser to accurately describe a fund's "recycling" practices for private funds that they advise. "Recycling" refers to contractual provisions in a fund's governing documents that permit the fund to add certain realized investment proceeds back to the capital commitments of investors.
- *Kirkland observations:* As detailed in the 2022 Risk Alert, the Staff is interested in whether advisers have accurately described recycling practices in fund disclosures or omitted material information from such disclosures. Recycling practices can in certain instances increase the amount of management fees collected by private fund advisers. To the extent recycling is permitted under a fund's governing documents, the Staff's principal focus is often on whether private fund advisers have adequately disclosed recycling provisions and any impact that recycling would have on management fees (e.g., increasing invested capital and management fees when such fees are based on invested capital). While we have seen a limited number of recent actual deficiencies in this area, in our experience this has not been a common deficiency among private fund advisers.

Adviser Personnel

- *Risk area:* The failure of a private fund adviser to adhere to the process established in a fund's LPA for departure of "key persons", as well as the failure to provide accurate information to investors that relates to the employment status of key portfolio managers who have left the private fund adviser.
- *Kirkland observations:* Private fund "key person" LPA requirements typically involve a notice and investor (e.g., LPAC) consent process to allow the continuation of a fund's investment period following departure of one or more designated adviser key

persons. Inclusion of this item in the 2022 Risk Alert reflects the importance of following the provisions in a fund's governing documents and making disclosure of material key investment personnel departures, even if such persons may not be designated LPA key persons. In our experience this is not a common deficiency among private fund advisers.

Disclosures Regarding Performance and Marketing

The Staff identified a number of deficiencies relating to private fund advisers using misleading track records or other marketing statements in violation of the Advisers Act antifraud provisions. The Staff also cited failures to retain books and records supporting the calculation of performance included in investment adviser advertising, as is required under the Advisers Act. With the new Advisers Act marketing rule ("Marketing Rule") becoming effective on November 4, 2022, we expect increased Staff focus on marketing materials used by private fund advisers, including the issues identified below. In addition, certain of the practices noted below are expressly addressed in the new Marketing Rule.

Use of Track Records — Misleading Material Information

- *Risk area:* Private fund advisers providing investors with inaccurate or misleading disclosures about an adviser's track record, including how: (i) applicable benchmarks were used; and (ii) the portfolio for the cited track record was constructed.
- *Kirkland observations:* Disclosure of relevant assumptions and limitations for track record performance has long been a focus of the Staff, and the examples cited in the 2022 Risk Alert — marketing a cherry-picked track record of select funds or failing to disclose information about the impact of fund leverage on performance — are common examples of the Staff's concerns around misleading track records and the adequacy of disclosure accompanying such track records. The Staff also cite the use of "stale" performance figures in presentations to potential investors or track records that fail to accurately reflect the impact of fees and expenses (e.g., use of gross returns without net returns). The new Marketing Rule will generally: (i) prohibit use of incomplete or untimely (i.e., not "fair and balanced") track records; (ii) require net returns to be presented; and (iii) require disclosure of elements material to the calculations (e.g., use of leverage).

Inaccurate Performance Calculations

- *Risk area:* Private fund advisers providing investors with track records that contain inaccurate performance calculations, such as 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).
- *Kirkland observations:* The Staff often reviews underlying support and data for performance calculations in order to identify instances of incorrect calculations or relevant assumptions and/or limitations that are not adequately disclosed in advertising materials. The 2022 Risk Alert underscores the importance for private fund advisers of ensuring that they retain adequate support for the calculation of track record figures and implement processes to ensure that the ultimate presentation of such figures is consistent with the underlying data (e.g., no mischaracterizations or assignment of data to wrong time periods). For projected rather than actual performance, the Staff has in certain instances viewed such performance as potentially misleading and required clear disclosure that it does not represent actual performance. Under the new Marketing Rule, private fund advisers will be subject to new restrictions and disclosure requirements governing the use of hypothetical performance, including projections.

Track Record Portability

- *Risk area:* The failure of a private fund adviser to maintain books and records that support “predecessor” performance relating to prior firm track records as required under the Advisers Act books and records rule or omitting material facts about such predecessor performance in marketing disclosures. As examples, the Staff cite deficiencies including: (i) marketing an incomplete prior track record; and (ii) advertising a track record notwithstanding that persons at the adviser were not primarily responsible for achieving the performance at the prior adviser.
- *Kirkland observations:* Where identified in an exam, the Staff will typically focus closely on the use of predecessor performance in marketing materials in order to validate that its use is consistent with existing SEC no-action guidance.[2] The Staff will also often inquire into records that support the calculation of predecessor performance figures, which can present significant complications to the use of a predecessor track record where departing private fund adviser personnel do not negotiate the contractual right to bring such records to their new employer. The new

Marketing Rule will replace existing SEC no-action guidance and contains express restrictions on the use by private fund advisers of predecessor performance, including requiring: (i) persons primarily responsible for the prior firm performance to be managing the fund for the adviser using the prior performance and the marketed fund to employ the same strategy; (ii) clear and prominent disclosure to be made that the track record was achieved at the predecessor firm; and (iii) supporting records to be maintained by the adviser using predecessor performance.

Awards and Other Inaccurate Claims

- *Risk area:* Private fund advisers providing misleading statements to investors regarding awards received by a private fund adviser or other claims not based in fact.
- *Kirkland observations:* The Staff often reviews the facts and disclosures surrounding marketing of industry awards, particularly where such awards are performance-based or have a "pay-to-play" element. As detailed in the 2022 Risk Alert, the Staff expects advisers to make full and fair disclosures about awards, such as the criteria for obtaining them, the amount of any fee paid to receive the award and any amounts that the adviser will pay to the award organization or other grantor for the right to promote the fact that they received the award. The Staff has also issued deficiencies where an adviser claimed their investments were "supported" or "overseen" by the SEC or the federal government more broadly. The new Marketing Rule establishes new requirements related to the use of third-party ratings, including disclosure regarding any compensation paid in connection with such rating.

Due Diligence

The 2022 Risk Alert highlights the fiduciary duty owed by private fund advisers to their clients (i.e., the funds), which includes a reasonable belief that the advice they provide is in the best interest of the relevant fund. The SEC takes the position that conducting reasonable investment due diligence is a component of a private fund adviser's fiduciary duty. Due diligence must consist of a "reasonable investigation" into an investment such that advice is not based on "materially inaccurate or incomplete information."

- *Risk area:* The failure of a private fund adviser to conduct a reasonable investigation into investments as part of the the due diligence process and in accordance with the advisers' policies and procedures or the failure of a private fund adviser to have policies and procedures outlining due diligence processes described in the adviser's PPMs or marketing materials. In particular, the Staff cites the failure of a private fund adviser to conduct a reasonable investigation of the compliance and internal controls of prospective investments, including the compliance infrastructure surrounding private funds in which an adviser's funds may invest. The Staff also cites the failure of a private fund adviser to perform adequate due diligence on service providers that they engage for key functions, such as alternative data providers and placement agents, as a compliance deficiency.
- *Kirkland observations:* While we have observed the Staff focus on the due diligence process in a limited number of recent exams, the inquiry is often on: (i) investments that have performed comparatively poorly or where the adviser restructured its investment interest; or (ii) perceived discrepancies between the diligence processes described in marketing or offering materials and those actually deployed in transactions. The inclusion of this observation may suggest an expanding focus by the Staff on the rigor and documentation of private fund advisers' diligence processes for investments and key service providers.

Hedge Clauses

A hedge clause is a clause in an agreement (e.g., standard of liability or exculpation in an LPA) or statement in disclosure documents that has the effect of limiting an adviser's liability. The SEC has recently stated that whether a hedge clause violates the Advisers Act antifraud standards depends on all the facts and circumstances and hedge clauses that purport to waive an adviser's fiduciary duty generally are inconsistent with the Advisers Act.[3] In the 2022 Risk Alert, the Staff stated that inclusion of "potentially misleading hedge clauses […] that purport 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" could be inconsistent with the Advisers Act antifraud rules.

While in our experience express waivers or limitations on Advisers Act fiduciary duties are uncommon, the SEC's "hedge clause" concern, which has also been stated in recent speeches and statements, appears to be growing and may be followed by increased Staff attention on examinations or other regulation.

For more information, please contact any of the authors noted below or your regular Kirkland attorney contact.

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1. *See* notice of SEC rulemaking here. ↩

2. *See* Horizon Asset Management, LLC, SEC Staff No-Action Letter (Sept. 13, 1996); Great Lakes Advisers, Inc., SEC Staff No-Action Letter (Apr. 3, 1992); Fiduciary Management Associates, Inc., SEC Staff No-Action Letter (Feb. 2, 1984); South State Bank, SEC Staff No-Action Letter (May 8, 2018). ↩

3. Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Rel. No. 5248 (Jun. 5, 2019). *See* KirklandPEN: 2019 Year in Review: U.S. Private Fund Manager Regulation. ↩

Authors

Norm Champ, P.C.

Partner / New York

Scott A. Moehrke, P.C.

Partner / Chicago

Michael Chu

Partner / Chicago

Matthew Cohen

Partner / Bay Area – San Francisco / Los Angeles – Century City

Marian Fowler

Partner / Washington, D.C.

Phil Vincent Giglio

Partner / Chicago

Nicholas A. Hemmingsen

Partner / Chicago

Alpa Patel, P.C.

Partner / Chicago

Eric L. Perelman

Partner / New York

Noah Qiao

Partner / New York

Jaime Doninger Schechter

Partner / New York

Reed T. Schuster

Partner / Chicago

Christopher J. Scully

Partner / Chicago

Ryan P. Swan

Partner / Chicago

Jamie Lynn Walter, P.C.

Partner / Washington, D.C.

Josh Westerholm, P.C.

Partner / Chicago

Related Services

Practices

- Transactional
- Investment Funds

Suggested Reading

- 31 January 2022 Kirkland AIM SEC Proposes Significant Amendments to Private Fund Manager Reporting on Form PF
- 22 December 2021 Kirkland AIM 2022 Private Fund Manager U.S. SEC/CFTC Filing Deadlines and Key Dates
- 18 November 2021 Kirkland AIM SEC Chairman Gensler Seeking to Bring “More Sunshine and Competition” to Private Funds; Division of Examinations Issues Observations on Fee Calculations

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