Simpson Thacher

Regulatory and Enforcement Alert

SEC's Division of Examinations Risk Alert Highlights Areas of Heightened Scrutiny for Private Fund Advisers

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Fresh on the heels of yesterday's announcement of proposed amendments to Form PF,[1] the SEC's Division of Examinations ("Exams") earlier today published a Risk Alert with its observations from recent examinations of advisers to private funds. The Risk Alert takes a decidedly skeptical view of the adequacy of many of the core functions of private fund advisers, including fee calculations, consultations with limited partner advisory committees and similar bodies, due diligence and marketing practices. Many of the themes observed by the Exams staff echo comments critical of the private fund industry by SEC Chair Gary Gensler, most notably in his speech at the Institutional Limited Partners Association in November 2021. Read together with the proposed amendments to Form PF, as well as Gensler's public remarks, the Exams Risk Alert underscores the SEC's seemingly increasing appetite for greater, more intrusive, and prescriptive oversight of the private fund industry.

Today's Risk Alert asserted that Exams had cited the following practices as deficiencies during recent private fund adviser exams:

- **Failing to act consistently with material disclosures to clients or investors.** This includes failing to obtain from LPACs or similar bodies informed consent required under fund disclosures; failing to follow practices described in fund disclosures regarding the calculation of Post-Commitment Period management fees, in particular with respect to reducing the cost basis of an investment after write-off, disposition, or similar scenario; failing to comply with limited partnership agreement liquidation and fund extension terms; failing to invest in accordance with the fund's investment strategy (sometimes referred to as style drift); not accurately describing, or omitting material information on, the fund's "recycling" practices (generally speaking, where a fund uses realized investment proceeds as capital from investors); and failure to follow fund disclosures regarding key persons.
- **Providing investors or prospective investors misleading disclosures on performance or marketing.** This includes providing inaccurate or misleading disclosures about a fund's track record; providing investors with inaccurate performance calculations; failing to maintain books and records supporting predecessor performance or omitting material facts about predecessor performance; misleading statements or omissions about awards received such as failing to disclose associated fees; and

[1] The proposed amendments would provide the SEC with unprecedented visibility into the ordinary-course affairs of advisers in the guise of financial stability and oversight. For more on this, *see* Simpson Thacher, *SEC Proposes Changes to Form PF That Could Prove Challenging*.

incorrect statements claiming that investments were "supported" or "overseen" by the SEC or U.S. government. The Risk Alert also alluded to the new marketing rule, which must be complied with by November 4, 2022.[2]

- **Due diligence shortcomings.** These include a lack of a reasonable investigation into underlying investments, including the compliance and internal controls of the underlying investments or funds; failing to perform adequate diligence on "important" service providers such as alternative data providers and placement agents; and failure to maintain reasonably designed or tailored due diligence policies and procedures.
- **Use of potentially misleading "hedge clauses" that improperly purport to waive or limit the Advisers Act fiduciary duty.** Here, the Risk Alert did not take a bright line approach and instead indicated that the impropriety of the use of "hedge clauses" will depend on the surrounding facts and circumstances.

As our readership may be aware, the SEC's Division of Enforcement has recently filed settled actions pertaining to some of the precise topics listed above—and it is expected that more are to come, including for minor infractions that may not have traditionally given rise to enforcement scrutiny. As SEC skepticism of the private fund industry intensifies, we urge private fund advisers to digest the observations in the Risk Alert as pertains to their particular business and operations and consider whether any tailored modifications to their compliance programs or practices may be desired.

[2] For more on this, *see* Simpson Thacher, *White Paper: Implications of New SEC Marketing Rule for Private Fund Sponsors*.

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