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SEC Issues Risk Alert on Alternative Investment Due Diligence

On Tuesday January 28, the staff of the SEC's Office of Compliance Inspections and Examinations ("OCIE" or "staff") issued a Risk Alert on the due diligence practices employed by investment advisers and financial planners before recommending alternative investments (e.g., hedge funds, private equity funds) and their managers. The Risk Alert offers both industry trends noted by the examination staff, as well as common compliance deficiencies. Below is a brief summary of notable compliance deficiencies, trends, and our takeaways for advisers, financial planners and alternative investment managers.

COMPLIANCE DEFICIENCIES

Annual Review. The staff observed that some advisers that recommended alternative investments failed to evaluate their alternative investment due diligence policies and procedures as part of their annual reviews.

Disclosure Issues. The staff observed that advisers' disclosures regarding due diligence (presumably on Form ADV Part 2A and in RFP responses) did not match their actual practices.

Marketing Claims. Similarly, the staff observed that marketing materials contained misleading or inaccurate claims of due diligence.

Access Person Investing. The staff observed instances where access persons were permitted to invest in a limited offering on more favorable terms (i.e., enhanced liquidity or reduced fees) than clients.

INDUSTRY TRENDS

Transparency. The staff observed increased requests from advisers for, among other things, position-level transparency. The staff noted, however, that managers were often reluctant to share such proprietary information.

Separate Account Management. The staff observed that some advisers recommended that their clients open a separate account with a manager (as opposes to a pooled vehicle) to, among other things, obtain better transparency and reporting.

Independent Administrator. The staff observed that some advisers were unwilling to recommend a private fund if the fund did not have an independent third-party administrator.

Verification of third-party service providers. The staff observed that advisers were independently verifying the relationships and assets with third-party service providers, such as administrators, custodians and auditors. The staff also noted that many advisers had started

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receiving periodic transparency reports from (and produced by) third-party administrators.

Background Checks. The staff observed that most advisers utilized third-party firms to conduct background checks on managers and key personnel.

Broader Reviews. The staff observed that advisers were expanding the scope of their reviews and increasing their focus on areas such as operational issues (e.g., valuation), legal documents, redemption and liquidity terms, onsite visits and audited financials.

KEY TAKEAWAYS

Advisers and financial planners who recommend alternative investments to clients, as well as fund-of-fund managers and overlay managers who oversee third-party funds or sub-advisers, should carefully evaluate whether they are susceptible to any of the above compliance deficiencies noted by OCIE. This evaluation should begin with a review of Form ADV Part 2A, offering documents and marketing materials to ensure that due diligence disclosures and representations are consistent with the adviser's due diligence policies, procedures and actual practices. These policies and procedures should be in writing and evaluated at least annually. Additionally, all investment advisers should evaluate their Code of Ethics policies and procedures relating to access persons investing in third-party and proprietary private funds, and ensure that any pre-clearance review of such documents takes into account conflicts of interest with client investments or recommendations.

With regard to the trends noted by OCIE, there is an increasing expectation (by both investors and regulators) for segregating duties and independent evaluations, through the use of independent administrators. As a result, managers of alternative investments who do not use an independent administrator should expect enhanced scrutiny from potential investors. At the same time, advisers that recommend alternatives should consider whether they need to increase the use of third-party evaluators such as background-check firms and what, if anything, they should be requesting from alternative investment administrators, custodians and other service providers.

A copy of the Risk Alert is available on the Commission's website at: http://www.sec.gov/about/offices/ocie/adviser-due-diligence-alternative-investments.pdf. Please feel free to contact us if you have any questions regarding this Risk Alert or any other SEC-related matter.

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