SEC's Examination Division Shares Observations Relating to Common Deficiencies Uncovered in Private Fund Manager Examinations

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On January 27, 2022, the SEC's Division of Examinations (EXAMS) shared observations relating to common deficiencies uncovered in the examination of private fund advisers over a five year period. These observations are a sequel to, and supplement, the observations EXAMS shared in their **June 2020 risk alert**. While this risk alert is aimed primarily at SEC-registered private fund advisers, we believe that the topics covered by the alert are largely relevant to other types of private fund advisers subject to SEC oversight (such as exempt reporting advisers).

Additionally, as is often the case with SEC guidance aimed at private fund managers, this risk alert may serve as a useful GRC best-practices benchmarking tool for non-US private fund advisers who are not subject to SEC oversight (directly or indirectly).

As has been the case with multiple SEC public remarks over the past year, in this risk alert, EXAMS highlights the significant growth and increasing prominence of the private fund industry to reiterate the case for increased scrutiny. The risk alert specifically notes that approximately 35% of SEC-registered investment advisers manage private funds whose collective assets approximate $18 trillion and goes on to state that in the past five years, private fund assets across liquid and illiquid strategies have experienced a 70% increase.

The observations highlighted in this risk alert are intended to both alert private fund investors to recurring risk areas, as well as serve as a helpful guide for compliance staff at private fund managers to enhance their compliance programs. Additionally, the observations further underscore the SEC's increasingly intensifying approach to the examination of private markets fund managers under the Gensler administration, **which ACA covered in a recent blog**. It is particularly noteworthy that a significant portion of these recent observations relate directly to private markets fund managers.

The observations, which are generally consistent with ACA's own experiences in advising private fund managers, are fairly focused and cover four key areas:

- Failure to comply with contractual arrangements with, and disclosures to, investors
- Misleading marketing practices (with an overwhelming emphasis on performance calculations and reporting)
- Inadequate investment due diligence and vendor due diligence processes
- Improper hedge clauses in fund governing documents

Additionally, it is worth noting that many of the issues covered by this risk alert have been the subject of multiple enforcement actions.

Contractual Compliance Failures

The SEC's focus on private fund managers' operational compliance with fund governing documents is hardly new. However, this risk alert is perhaps the most detailed single publication from the SEC focused on this topic – and, as such, underscores how important this topic has become to the SEC. Further, this risk alert demonstrates that EXAMS is not going to shy away from spending the time and energy needed to understand and forensically test very complicated and often opaque economic provisions in fund governing documents (such as recycling provisions).

As retail investors increasingly access private markets (e.g., through their pension funds' allocations to private markets managers), we anticipate that the SEC's focus on monitoring and enforcing General Partner (GP) - Limited Partner (LP) contractual risk-spreading will only increase – especially when taking into account the long-term and closed-end nature of investing in private markets funds. In addition, with the volatility resulting from "meme" stocks and other retail interest in investing over the past year, the SEC staff is inquiring how hedge fund managers have responded and whether any changes in investing practices may be inconsistent with fund governing documents and related disclosures.

Further, this topic is one that LPs are increasingly concerned about and this has translated into an increase in formal and informal requests from LPs requesting their fund managers to provide certifications and/or evidence of such compliance on a periodic basis.

In summary, as the complexity of private fund governing documents and the scale of related side letters modifying the terms set out in such governing documents proliferate, the importance of using tech-based tools to efficiently manage operational obligations under these legal documents (and to document compliance) has never been greater. To learn more about how firms can effectively leverage technology, like ACA's ComplianceAlpha®, and manage their obligations under complex legal documents, please [view our webcast here].

EXAMS has specifically called out the following types of operational compliance failures (many of which may have resulted from private fund managers' inadequate awareness of terms set forth in fund governing documents):

Failure to Obtain Informed Consent from Limited Partner Advisory Committees (LPACs) Where Contractually Required

Consistent with multiple enforcement actions over the past few years and ACA's examination experiences, EXAMs noted that they have uncovered the following types of failures relating to the involvement of LPACs (or lack thereof) in managing conflicts:

- Failure to obtain LPAC consent where explicitly required under fund governing documents
- Failure to timely obtain LPAC consent by obtaining consent after the fact
- Failure to obtain proper consent of the LPAC by providing incomplete information necessary for the LPAC to make informed decisions (including a failure to provide all of the types of information specifically required under fund governing documents in connection with seeking LPAC consent for a specific type of transaction/conflict)

Takeaway: While consent by an LPAC or similar committee is not a "safe harbor" for conflict disclosures and consents, it is a standard in the private fund industry, and the SEC staff will generally request copies of all communications and related materials presented to such advisory committees to confirm whether the manager is accurately describing the conflict (so informed consent can be given), and scrutinizing fund governing documents to determine whether all prescribed conflicts have been presented to such committees. ACA recommends that managers communicate with fund counsel to err on the side of caution if there is any question about whether a potential conflict should be presented to the committee and whether affirmative consent is needed.

Contractual Compliance Failures (Continued)

Failure to Accurately Calculate Management Fees During the Post-Investment Period

While SEC exam deficiencies and enforcement actions around improper calculations of management fees during the post-investment period are not new, EXAMS' below observations contain some of the most detailed and concrete feedback from the SEC we have seen to date. EXAMS specifically highlights the following issues that resulted (or may have resulted) in over-charging investors:

- Private fund advisers whose fund management fee bases stepped down to actively invested capital after the end of the investment period did not appropriately adjust the management fee base to reduce/exclude the cost basis of an investment that had been partially or entirely disposed of or written down/off.
- In connection with specifying the management fee base for post-investment period fees, Limited Partnership Agreements (LPAs) did not clearly define critical terms such as "impaired," "permanently impaired," or "permanently written down." Additionally, managers did not implement internal policies and procedures clarifying these terms so as to ensure clearly defined and consistent application. As a result, managers may have inconsistently applied management fee base adjustments.

Takeaway: As fund managers did with vague fund expense provisions in the early years of Dodd Frank, here as well, private markets fund managers should carefully review management fee step down formulas in their existing fund governing documents and seek to cure any ambiguities with enhanced ADV disclosures and internal policies and procedures. Such an approach will also better ensure that managers achieve consistency in determinations of when to write down or write off an investment in situations where such determinations impact their management fee revenue stream. Additionally, on a go-forward basis, when launching new funds, managers should ensure they work closely with fund counsel to achieve greater clarity and precision around these issues within the governing documents itself.

Failure to Comply with LPA Liquidation and Fund Extension Terms

Consistent with ACA's own observations relating to EXAMS' increased scrutiny of how managers are handling operational compliance obligations and conflicts of interest relating to fund extensions and continuation funds, EXAMS noted multiple instances where their staff had observed advisers that extended the terms of private equity funds without obtaining the required approvals or without complying with the liquidation provisions described in the fund governing documents, which, among other things, resulted in potentially inappropriate management fees being charged to investors.

Takeaway: ACA recommends that private fund managers considering extending their funds' operations beyond the standard term carefully examine the mechanism provided in the applicable fund governing documents to achieve such extensions (e.g., one year at a time with LPAC approval and for a maximum of two years). Additionally, to the extent such managers seek to extend a fund's term any further, it is imperative they carefully memorialize in the amendment to the fund governing documents all relevant aspects of such an extension (including management fee terms) in connection with obtaining investors' informed consent.

Contractual Compliance Failures (Continued)

Failure to invest in Accordance with Provisions in Fund Governing Documents Regarding investment Strategy

EXAMS staff observed private fund advisers that did not comply with investment limitations in fund disclosures. For example, the staff observed private fund advisers that implemented an investment strategy that diverged materially from what was described in fund governing documents. EXAMS staff also observed advisers that caused funds to exceed leverage limitations detailed in fund governing documents.

Takeaway: Managers should consult with outside counsel on whether any shifts in investment strategies or new investments may require updates to governing documents and/or consent from investors, e.g., the LPAC. Compliance should also confirm that any monitoring of restrictions, such as sizing, concentration, or leverage, is providing sufficient advance notice of any potential violation of a fund's restriction or limitation.

Failures Relating to Key-Man Events

EXAMS staff observed private fund advisers who did not follow relevant provisions in fund governing documents relating to key-man events (including failure to disclose such events to investors).

Takeaway: When a "new generation" of investment leads take over from founders moving out of the business, or in a more consultative role, managers must confirm that such transitions are adequately disclosed to investors, as such changes may result in additional diligence by existing investors, as they evaluate whether to remain invested in the funds. Such disclosures should be transparent about any changes in process or procedures resulting from the transition, especially if the investment strategy may be shifting into new or different areas.

Failures Relating to Recycling Provisions

EXAMS staff observed private fund advisers whose "recycling" practices did not comply with provisions in fund governing documents addressing such matters. In some instances, this failure may have caused private fund advisers to collect excess management fees.

Takeaway: This is perhaps the first time ACA has seen EXAMS comment publicly on compliance with one of the most complex provisions in fund governing documents – those addressing recycling of capital. This comment is especially notable as it demonstrates EXAMS staff will not shy away from examining and testing compliance with complex legal provisions that have hitherto been the domain of fund counsel.

ACA notes that such provisions are often inherently confusing (including for managers) and, as such, many investors seek clarity via side letter on how they are intended to work in practice.

While many large institutional investors favor aggressive recycling – as it will typically result in more of their capital being put to use than would otherwise be the case without having to pay additional management fees – smaller and less sophisticated investors who are less willing to take investment risks with their distributions often seek limits on recycling. As the investor base for private markets funds increasingly diversifies to include a greater degree of the latter types of investors, unlimited recycling provisions have become less common and, as such, managers need to more carefully monitor and, where needed, curb their recycling practices to ensure contractual compliance.

Finally, while recycling is typically not intended to increase the management fees payable by a fund, the fact that EXAMS staff have uncovered instances of management fees being erroneously collected on recycled capital illustrates the need for external fund counsel and/or internal counsel to provide clear and practical guidance to fund finance teams on this issue.

Misleading Marketing Activities

Over the past few years, ACA has noticed a steady increase in the number of enforcement actions and exam deficiencies relating to a wide array of misleading (or otherwise loose) marketing practices (performance- and non-performance-related). In addition to marketing practices, EXAMS staff also observed that private fund managers had failed to preserve required books and records that form basis for performance or rate of return calculations presented in marketing materials.

It is partly due to some of these issues as identified by the EXAMS staff, that FINRA in July 2020 released guidance around private placement offerings in retail communications. Under the guidance, they had recognized how performance calculation and presentation across private fund managers is not standardized and in order to mitigate the risks associated with presenting inaccurate or misleading performance results, FINRA had provided the following guidance around IRR calculations and presentations.

> "Investment programs such as private equity funds and REITs may have a combination of realized investments and unrealized holdings in their portfolios. Where the program has ongoing operations, FINRA interprets Rule 2210 to permit the inclusion of IRR if it is calculated in a manner consistent with the Global Investment Performance Standards (GIPS®) adopted by the CFA Institute and includes additional GIPS-required metrics such as paid-in capital, committed capital and distributions paid to investors."

This risk alert provides the industry, private fund managers and asset owners alike, another reason to rethink the application and adoption of performance standards like the GIPS standards, which promotes greater transparency into the performance calculation and reporting process to prospective clients.

EXAMS' observations (summarized below) are generally consistent with our experiences and underscore the increasing intensity of the SEC's focus in this area. We anticipate that in light of continued aggressive marketing activities against the backdrop of a very competitive fundraising environment, and the SEC's new marketing rule, that fund managers will need to comply with by early November 2022, the SEC's focus will significantly increase.

Misleading Marketing Activities (Continued)

Misleading Material Information About a Track Record

EXAMS staff observed private fund advisers that provided misleading disclosures about their performance track record, including use of benchmarks or construction of the track record. For example, the staff observed private fund advisers that cherry-picked performance track records of one fund or a subset of funds. Another example noted was missing disclosures around material impact of leverage on fund performance. EXAMS staff also observed advisers that used stale performance in their marketing materials and track records that did not factor in for fees and expenses appropriately.

Additionally, even though the risk alert does not specifically note the following example, ACA has observed during their reviews a lack of books and records substantiating the reasonableness of hypothetical performance such as target returns and projected or pro-forma returns that are presented very frequently while fundraising for new funds.

Takeaway: ACA recommends that fund managers seeking to advertise performance in their marketing materials should take a closer look at the construction of the performance track record, calculation methodologies applied, along with appropriate presentation and disclosure of the same. In order to do so, ACA suggests that advisers should conduct a yearly mock exam focused on their performance track record construction, performance calculation methodologies, books and records review supporting performance, and marketing material review either internally or using outside third party firms.

Below are some specific recommendations as it relates to the observations made by the staff:

» Advisers should present all related performance whenever performance is shown in an advertisement which would avoid any perception of cherry-picking of better performing funds or track records.

» Advisers should disclose the presence, use, and impact of leverage on fund performance. Advisers should consider the effects of subscription facilities on performance and, if material, should calculate returns both with and without the benefit of the subscription facility.

» While private funds are excepted from the new marketing rule's prescribed time periods, the SEC has made it clear that delays in performance reporting should be minimal. Where possible, firms should calculate performance using actual, current fair market value and should update returns in a timely manner.

» Advisers should also consider reviewing internally or using a third party for their performance calculation methodologies to make sure they are following industry best practices and appropriately factoring in fee and expense impacts.

Misleading Marketing Activities (Continued)

Inaccurate Performance Calculations

EXAMS staff observed private fund advisers that presented inaccurate performance calculations to investors. For example, the staff observed private fund advisers that used 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, thereby leading to inaccurate and potentially misleading disclosures regarding performance.

Takeaway: Fund managers should make an effort to understand best practices with regards to the assumptions for timing and amounts of cash flows, along with terminal value assumptions. ACA considers the GIPS® standards as best practice, and highly encourage managers to review the calculation methodologies as outlined in the standards for private fund return calculations.

One of the weakest points of the performance calculation process is the implementation of technology. Many private fund managers spend a significant time updating clunky templates or simply creating a new file to suit their immediate needs. In many cases, changes to templates over time are not recorded or reviewed. At larger firms that employ various fund accounting teams to calculate returns, these teams are often utilizing their own custom calculation templates. This can lead to inconsistent implementation assumptions inconsistently from fund to fund within the same firm. This also inherently creates additional compliance obligations as the disclosures must be reviewed for each different calculation template to ensure that they accurately represent the methodologies and assumptions employed. The likelihood of material errors in the calculation and presentation of performance increases where the performance measurement and reporting function is siloed to a single person(s).

While implementing or upgrading technology may be prohibitively expensive for many firms, ACA recommends conducting either internal audits or bringing in a third party to conduct an independent review of input data, including cash flows and terminal values, used in performance calculation to ensure that the firm's implementation agrees to industry best practice, their documented assumptions and disclosures. This can be an efficient and cost-effective control process.

ACA also recommends advisers create accountability and oversight around performance construction and calculations. There is considerable variability in the roles and responsibilities of those charged with the calculation of performance results. We have seen fund accounting teams, investor relations, marketing, portfolio analytics, and even compliance professionals performing these roles.

Performance measurement and reporting function touches all areas of the firm. The users of performance (i.e., investor relations, marketing, portfolio management) and those performing the calculations (i.e., finance, accounting, portfolio analytics) must work together, and with compliance, to ensure that the performance information provided to investors is complete, accurate, and fully disclosed.

In order to create this oversight and accountability, ACA recommends implementing policies and procedures around the performance calculation process which is a critical first step toward managing a performance measurement function capable of ensuring consistent and accurate results.

Misleading Marketing Activities (Continued)

Portability - Failure to Support Adequately, or Omissions of Material information About Predecessor Performance

EXAMS staff observed private fund advisers that did not maintain books and records supporting predecessor performance at other advisers as required under Advisers Act Rule 204-2(a)(16). In addition, the staff observed private fund advisers that appeared to have omitted material facts about predecessor performance. For example, the staff observed private fund advisers that marketed incomplete prior track records or advertised performance that persons at the adviser were not primarily responsible for achieving at the prior adviser.

Takeaway: ACA recommends that fund managers seeking to advertise predecessor performance ensure that they meet portability criteria as defined by SEC, and that they have adequate books and records to support the calculation of performance. Where the firm is unable to recalculate the performance and where books and records are incomplete, performance should not be shown.

Misleading Statements Regarding Awards or Other Claims

EXAMS staff observed private fund advisers that made misleading statements regarding awards they received. For example, the staff observed private fund advisers that marketed awards received, but failed to make full and fair disclosures about the awards, such as 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. The staff also observed advisers that incorrectly claimed their investments were "supported" or "overseen" by the SEC or the United States government.

Takeaway: ACA recommends that fund managers seeking to advertise awards obtain as much information as possible from the industry association or other group issuing the award and disclose these details in their marketing materials and disclose these in robust detail in marketing materials where such awards are highlighted.

The information we have seen the SEC expect to be disclosed, at a minimum, include those EXAMS noted above as well as other important aspects such as the universe and types of managers considered for the award, along with other critical details relating to the selection/filtering process, such as whether the award only covers funds of a certain vintage year and whether any minimum performance requirements applied to be considered for the award.

Additionally, in instances where those awards are unable (or unwilling) to provide the above-mentioned critical details, which ACA has noticed from time to time, fund managers should seriously evaluate the regulatory and reputational risks of advertising such awards.

Inadequate Investment, Operational, and Vendor Due Diligence

While EXAMS' observations relating to inadequate investment diligence are not new, they underscore how important this area has become to the SEC's regulatory agenda. ACA has noticed a sharp uptick in SEC exam deficiency findings in this space consistent with EXAMS' observations.

ACA has also noticed that since the onset of the COVID-19 pandemic, deep-dive enquiries into how fund managers are monitoring and evaluating data-security and transmission of material nonpublic information (MNPI) risks at their vendors on a periodic basis (rather than simply at the outset of an engagement), and how such efforts are documented, are increasingly common in broad-scope exams.

Lack of a Reasonable Investigation into Underlying Investments or Funds

EXAMS staff observed advisers that did not perform reasonable investigations of investments in accordance with their policies and procedures, including the compliance and internal controls of the underlying investments or private funds in which they invested. In addition, the staff observed advisers that failed to perform adequate due diligence on important service providers, such as alternative data providers and placement agents.

Takeaway: Fund-of-Funds managers, as well as direct investment managers who invest in third-party investment advisory businesses or operating portfolio companies, should ensure that as part of their overall due diligence of these investment targets, they sufficiently examine the corporate governance, risk management and compliance culture and controls in place at the investment advisory firms they are seeking to invest in. For example, while seeing to make a strategic (or other type of investment) in a third party manager on behalf of their funds, fund managers should obtain sufficient information to reasonably evaluate: (i) the quality of such manager's GRC programs and operational controls, and the robustness of periodic program reviews, and (ii) whether and how GRC issues uncovered in internal or external audits have been resolved.

In addition, confirmation that the third party manager or fund is following its claimed investment mandate and is not engaging in "style drift" over time is an important element of the diligence process, along with any key person departures or other material changes in business in the underlying manager or fund that would require a manager to reassess its initial allocation decision.

Similarly, while evaluating an investment in an environmental clean-up portfolio company, undertaking (or retaining a qualified third party to undertake) a thorough assessment of the health-and-safety controls in place at such company would be appropriate.

In the context of managing data-security risks relating to vendors who have access to sensitive information about a private fund managers' business (including fund data) and investor PII), managers should carefully identify which vendors should be included in their periodic vendor due diligence programs, obtain and evaluate SOC-type reports and/or responses to such managers' due diligence questionnaires, risk rate such vendors (based on both the level of sensitive information they have access to as well as the quality of their data security controls) and thoroughly document all of the foregoing results.

Simply taking the anachronistic position that a manager uses blue-chip vendors whose data security efforts are beyond a manager's control (or who will not share any information relating to such efforts with customers) or relying on the blind belief that such vendors likely have top notch controls and undertaking due diligence on them is not a worthwhile exercise are approaches that EXAMS has repeatedly down-voted from the very early years of Dodd Frank.

Inadequate Investment, Operational, and Vendor Due Diligence (Continued)

Furthermore, the risk alert expressly identifies alternative data as an area of concern in regard to vendor diligence, which has been an examination priority for the past two years.

For example, the SEC staff is inquiring whether the compliance department is involved in the initial diligence of alternative data providers and the onboarding process; how areas of concern or "red flags" are identified during the diligence process; and what steps managers are following when either resolving them or electing to decline the vendor. Following a manager's onboarding of an alternative data vendor, SEC exam team members are typically requesting information concerning how the data is being used as part of the investment decision-making process, the ongoing diligence of alternative data vendors, including the cadence and formality of periodic reviews.

Hedge fund managers are recommended to review their initial and ongoing due diligence practices concerning the use of alternative data vendors and confirm that compliance procedures are followed consistently, and that adequate documentation is maintained of the firm's monitoring of such vendors.

Inadequate Policies and Procedures Regarding Investment Due Diligence

EXAMS staff observed private fund advisers that did not appear to maintain reasonably designed policies and procedures regarding due diligence of investments. For example, the staff observed private fund advisers that outlined a due diligence process in fund disclosures, but did not maintain policies and procedures related to due diligence that were tailored to their advisory businesses.

Takeaway: ACA notes that while EXAMS staff started to push private markets fund managers to formalize their investment due diligence (initial and ongoing) and portfolio management processes prior to COVID-19, this push has become more prevalent since COVID-19. There is little doubt that risks from inadequate due diligence and oversight of portfolio companies are real.

For example, a firm that acquired a portfolio company based on strong investment fundamentals and the promise of growth and increased revenues at the portfolio company, but without conducting thorough due diligence on the quality of such company's financial accounting and reporting processes, likely has had to expend a fair bit of time, energy and expense post-due diligence in enhancing these processes. Through this clean-up exercise, such a firm may have realized that the fundamentals of the acquired company may not be as strong as initially surmised, which could force the firm to significantly revise its risk/return expectations for the investment (to the detriment of fund investors).

Currently, we are seeing EXAMS staff explore whether fund managers are being consistent in their initial and ongoing due diligence processes from deal to deal on common denominator risks (e.g., cybersecurity, background checks on senior management of portfolio companies, pending litigation (if any), and quality of financial accounting and reporting processes at portfolio companies). While it would be appropriate to document due diligence activities focused on risks unique to a particular deal via the due diligence packet for that deal, the overarching due diligence processes should address how the firm will, in a relatively consistent manner, evaluate risks that are common to all deals.

EXAMS has also been focusing on hedge fund managers' due diligence practices, especially where the manager has broadened its investing into illiquid strategies, such as private investments, PIPEs and SPACs. The SEC staff has raised concerns whether managers have adequate expertise in diligencing such investments and if the firm's procedures adequately address the risks associated with such investing. Hedge fund managers that have broadened their investment strategy into more illiquid or private strategies should ensure that policies and procedures have been adopted to appropriately address the underlying risks associated with these types of investments, and that any statements made in governing documents or disclosures to investors are consistently followed in practice.

Inadequate Investment, Operational, and Vendor Due Diligence (Continued)

The SEC is also looking to ensure that fund managers' policies cover the entire spectrum of the various elements in the lifecycle of an investment from how deals are sourced and due-diligenced. As such, ACA recommends, based on our examination experiences, that private markets fund managers investment due diligence policies address the following topics at a minimum:

- Various formalities that need to be completed between initial due diligence and completion of deals (including initial and final approvals; additional due diligence; submission of indications of interest, letters of intent and term sheets, and investment memos)
- Ongoing due diligence and portfolio company oversight processes (including portfolio company reporting processes)
- Processes around exiting portfolio companies (including how bids are evaluated and overall determinations around when and on what terms to exit)

ACA also recommends that hedge fund managers consider the following topics in their due diligence procedures:

- The sourcing of potential investments, including the use of third parties, alternative data, and screening processes
- How investments are approved, such as there are exceptions for analyst-directed or "toehold" positions, and the approval process around initial and secondary issuance participation (and resulting allocation)
- The ongoing monitoring process for long, short, and derivative (e.g., hedging) positions, including related risk management and leverage limits associated with the sizing of positions, consistent with the governing documents of the fund's disclosures

ACA notes that while most private fund managers may have been relatively reticent to provide disclosures to investors about their initial and ongoing due diligence processes prior to COVID-19, since COVID-19, there has been a proliferation of very detailed (and often very aspirational and/or vague) disclosures on this topic – often as a result of pressure from prospective investors and/or a desire to remain competitive in a crowded fundraising environment.

We have noticed multiple instances where such managers are either not complying with various undertakings in such disclosures and/or not maintaining documentation or implementing processes relating to such matters. We recommend that managers pragmatically evaluate their ability to comply with their due diligence disclosures and, where deemed appropriate, scale back on such disclosures.

Inappropriate Hedge Clause in Fund Governing Documents

EXAMS' choosing to call out inappropriate hedge clauses in fund governing documents appears to reflect their growing concerns around the proliferation of such clauses, which ACA has also noticed.

For example, we have increasingly noticed provisions in fund governing documents seeking to waive or improperly modify fund managers' obligations under the Investment Advisers Act (such as waiver of custody rule-imposed fund audit requirements or seeking blanket consent for principal transactions so as to avoid having to go to investors and/or fund LPACs on a transaction-by-transaction basis). In this risk alert, EXAMS reiterates that such provisions are not enforceable.

Another area ACA has seen EXAMS routinely comment on during the course of examinations are vague provisions in fund governing documents seeking to waive any and all fiduciary duties. As noted in the SEC's **Interpretation Regarding Standard of Conduct for Investment Advisers**, a blanket waiver of fiduciary duties or all conflicts of interest are not enforceable regardless of the sophistication of the applicable private fund investors. We recommend fund managers and their fund counsel carefully consider how best to qualify such provisions to ensure compliance with the Advisers Act.

By way of illustrative example, consider, at a minimum, modifying the below vague conflict waiver with the bolded language added at the very end.

> *"The Adviser and its respective affiliates may encounter potential conflicts of interest in connection with the Funds' interests, assets or activities (including certain conflicts of interest as among the interests of different Fund vehicles). If any matter arises that the Adviser determine in its good faith judgment constitutes an actual conflict of interest, the Adviser may take such actions as may be necessary or appropriate to ameliorate the conflict and upon taking such actions the Adviser will be relieved of any responsibility for such conflict. By acquiring an Interest in a Fund, each investor will be deemed to have acknowledged the existence of any such actual or potential conflicts of interest and to have waived any claim with respect to any liability arising from the existence of any such conflict of interest.* ***Notwithstanding the foregoing, nothing contained in this paragraph or elsewhere in this agreement shall constitute a waiver by any investor of any of its legal rights under applicable U.S. federal securities laws or any other laws whose applicability is not permitted to be contractually waived."***

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We help our clients manage **regulatory compliance**, **cybersecurity and risk**, and **performance verification** through our consulting, **outsourcing**, and **technology solutions**.

Our services and solutions include standard and customized compliance packages; cybersecurity and technology risk assessments; GIPS® compliance and other performance services; and a variety of business advisory, technology, and training solutions for financial services firms.

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Our global team of regulatory compliance professionals includes former SEC, FINRA, FCA, CFTC, NFA, and state regulators, as well as former senior managers from prominent financial institutions and advisory firms. We work with compliance and legal professionals to review and develop compliance programs based on best practices, current regulatory requirements, and robust oversight processes.

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