NATIONAL EXAM PROGRAM
RISK ALERT

This Risk Alert summarizes OCIE staff observations on the due diligence practices of certain investment advisers that manage and/or recommend alternative investments to their clients.

Practices employed by some advisers that may provide greater transparency and that independently support the information provided by underlying managers include: (i) the use of separate accounts to gain full transparency and control; (ii) the use of transparency reports issued by independent fund administrators and risk aggregators; (iii) the verification of relationships with critical service providers; (iv) the confirmation of existence of assets; (v) routinely conducting onsite reviews; (vi) the increased emphasis on operational due diligence; and (vii) having independent providers conduct comprehensive background checks.

By the Office of Compliance Inspections and Examinations[1]

Volume IV, Issue 1 **January 28, 2014**

INVESTMENT ADVISER DUE DILIGENCE PROCESSES FOR SELECTING ALTERNATIVE INVESTMENTS AND THEIR RESPECTIVE MANAGERS

For at least the past six years, staff in the Office of Compliance Inspections and Examinations (the "staff" and "OCIE" respectively) have observed and outside studies have indicated that investment advisers, including pension consultants, are increasingly recommending alternative investments to their clients.[2] Investment advisers are fiduciaries and thus must act in their clients' best interests.[3] An adviser that exercises discretion to purchase alternative investments on behalf of its clients, or that relies on a manager[4] to perform due diligence of alternative investments, must determine whether such investments: (i) meet the clients' investment objectives; and (ii) are consistent with the investment principles and strategies that were disclosed by the manager to the adviser (as set forth in various documents, such as advisory disclosure documents, private offering memoranda, prospectuses, or other offering materials provided

1 The views expressed herein are those of the staff of OCIE, in coordination with other Securities and Exchange Commission ("SEC") staff, including in the Division of Enforcement's Asset Management Unit and the Division of Investment Management. The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

2 Alternative investments include private funds such as hedge funds, private equity, venture capital, real estate, and funds of private funds. According to a June 2012 research report by McKinsey & Company, the Assets Under Management for global alternative investments have grown to a record $6.5 trillion, having grown at a five-year rate of more than seven times that of traditional asset classes. The study defines alternative investments in a similar way as noted above. McKinsey & Company, *The Mainstreaming of Alternative Investments* (June 2012).

3 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), *available at* http://www.sec.gov/about/offices/ocie/iainfo/capitalgains1963.pdf.

4 As used in this Alert, the term "adviser" refers to registered investment advisers that the staff examined, and "manager" refers to the managers of the alternative investments that the adviser recommends to its clients.

by the manager).[5] The due diligence process can be more challenging for alternative investments due to the characteristics of private offerings, including the complexity of certain alternative investment strategies.

The staff examined[6] the due diligence and related investment advisory processes of certain advisers to pension plans and funds of private funds in order to evaluate how these advisers: (i) performed their due diligence; (ii) identified, disclosed, and mitigated conflicts of interest (*e.g.*, benefits to the adviser or its employees for allocations made to private funds); and (iii) utilized experienced investment teams when evaluating complex investment strategies and fund structures.[7]

I. Staff Observations – Industry Practices

A. Industry Trends

The staff observed several widespread trends regarding advisers' due diligence processes.[8] Several of these observations are noted below.

i. Advisers Are Seeking More and Broader Information and Data Directly from Managers of Alternative Investments

- *Position-Level Transparency.* The staff noticed increased requests from advisers, as compared to the staff's experience in prior time periods, for position-level transparency of the alternative investments. This observation was confirmed through discussions with the advisers. The staff further noted that while some managers were willing to provide additional transparency, others were reluctant to share detailed information about their alternative investments. In particular, these managers were sensitive to sharing position-level

[5] The staff observed that, in general, registered advisers performed distinct due diligence reviews of both the alternative investment fund under consideration and its manager.

[6] The staff conducted more than ten examinations of SEC-registered investment advisers, pursuant to Section 204 of the Investment Advisers Act of 1940 ("Advisers Act"). The staff's examinations focused on advisers that invested in or recommended private fund and fund of private fund investments (*e.g.*, hedge funds and private equity funds). As of the time of the examinations, these advisers managed approximately $2 trillion in investor assets. The staff did not examine commodity pools and registered investment companies that pursue alternative strategies.

[7] Staff from the Division of Enforcement brought a settled enforcement action, which alleged that certain fund advisers did not perform two of the five elements of the due diligence evaluation that they had represented to their clients they would undertake. In addition, the staff alleged that the advisers failed to adequately respond to information that they received, which suggested that the identity of the fund's outside auditor was in doubt and that there existed a potential conflict of interest between one of the fund's principals and its purported outside auditor. *In the Matter of Hennessee Group LLC and Charles J. Grandante*, Investment Advisers Act Release No. 2871 (April 22, 2009), *available at* http://www.sec.gov/litigation/admin/2009/ia-2871.pdf.

[8] The staff does not take a position regarding the compliance effectiveness or ineffectiveness of the industry practices discussed in this section of this Risk Alert. The adequacy of the industry practices discussed in this Risk Alert can be determined only with reference to the profile of each specific firm and other facts and circumstances.

information, which they felt may compromise their ability to execute their strategies. Position-level transparency was typically used by the advisers' risk assessment teams to: (i) fine-tune analyses of market sector exposures; (ii) identify position concentrations across the client's entire portfolio; and (iii) identify individual positions that may present risks that were anomalous or inconsistent with managers' stated investment strategies. The position-level transparency ultimately provided to the advisers by the alternative investment managers tended to be the result of a process of negotiation between advisers and managers and depended on several factors, including the relative influence of the investors and whether the manager viewed position-level transparency as sensitive proprietary information.

- *Separate Account Management.* Some advisers recommended that their clients' assets be managed within a separate account to: (i) provide full transparency and greater control over how the assets are invested (the manager's authority over the assets is limited to trading authority); (ii) allow for better monitoring of the investment portfolio's liquidity and valuation; and (iii) reduce the ability of a manager to misappropriate client assets or charge unauthorized fees or expenses. The staff understands that many managers continue to prefer a pooled investment structure, based on their beliefs that such structures minimize expenses, increase operational efficiency, and reduce the risk of inequitable treatment of investors. As with the degree of position-level transparency, the staff noted that the resulting investment structure was increasingly determined through a negotiation between managers and advisers. The staff also observed that the key factors in such negotiations were the susceptibility of assets to misappropriation, transparency into the alternative investment funds' portfolio holdings, expenses incurred, and efficiency of operations.

ii. Advisers Are Utilizing Third Parties to Supplement Analyses and Validate Information Regarding Alternative Investments

- *Portfolio Information Aggregators (Risk Aggregators).* The staff noticed, as compared to previous staff observations and as confirmed by the advisers examined, that advisers increased their use of portfolio information aggregators. Aggregators are generally third-party service providers that receive detailed portfolio-level information from private alternative investment funds, aggregate that information and transmit the aggregated information to advisers conducting due diligence. Advisers used the aggregated information to make broad assessments of the risks of the particular alternative investments. The aggregated information provided to advisers by aggregators was intended to control the disclosure of sensitive information regarding the alternative investment fund's specific positions. The staff observed that in some cases the use of aggregators was a compromise between the adviser and the manager to resolve differing preferences for position-level transparency between investors and managers.

- *Third-Party Service Provider Verification of Relationships and Assets*. The staff observed that many advisers were independently verifying alternative investment relationships and assets with key third-party service providers, such as administrators, custodians, and auditors. As gatekeepers, these key service providers play a very important role for private alternative investment funds. As such, the staff observed that due diligence professionals appeared to have placed a greater emphasis on verifying the existence of these relationships, and, in some cases, also were verifying that the assets were in fact serviced by the administrator and held at the custodians identified. In addition, the staff observed that if the adviser was not familiar with a service provider, some advisers would conduct a certain amount of due diligence on the service provider in an effort to ensure that the service provider can provide an adequate level of service to the alternative investment.

- *Independent Administration*. The staff observed that some advisers would not make a new investment or recommendation in a private alternative investment fund if the private fund did not have an independent third-party administrator. While not required to do so by law, the staff observed that many advisers invested exclusively with managers that engaged an independent administrator to conduct comprehensive fund administration services such as performing net asset value calculations, fund accounting, trade reconciliation, and processing and recording shareholder activity. The staff understands that the genesis for such an adviser-mandated requirement is the belief that independent administrative services may mitigate certain investment and operational risks, such as the misappropriation of investor assets, and ensures segregation of duties.

- *Third-Party Administrator-Issued Transparency Reports.* The staff observed that many advisers have started receiving "transparency reports" directly from, and independently produced by, third-party administrators for the benefit of alternative investment investors. These reports are designed to provide investors with periodic reporting and an increased level of transparency with respect to the alternative investments' positions. An administrator's report typically includes information about an alternative investment's: (i) net asset value and the percentage of its investments that are confirmed by the administrator with independent custodians; (ii) custodians holding its investments; (iii) percentage of investments that are priced by a third-party administrator; and (iv) assets and liabilities which are measured at "fair value" and are categorized using the fair value hierarchy (Level 1, 2, or 3) established under FASB ASC 820, Fair Value Measurements.

- *Independent Background Checks*. The staff observed that most advisers employed the services of third-party firms to conduct comprehensive background checks on the managers and their key personnel. The staff also observed that many advisers implemented the use of background checks to supplement their own due diligence processes. The background check services were typically outsourced to third-party firms specializing in such services and often included investigating employment history, legal and regulatory matters, news sources, and independent reference checks.

- *Regulatory History Review*. The staff observed that some advisers utilized FINRA BrokerCheck, a publicly available tool,[9] to research the backgrounds of current and former FINRA registered brokerage firms and individual broker-dealer registered representatives. Along with BrokerCheck, the staff also observed that some advisers reviewed regulatory filings, such as Form ADV — available on the Commission's Investment Adviser Public Disclosure website[10] — and requested that the manager provide the adviser with any

9 *Available a*t http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

10 *Available at* http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx

examination-related letters from the SEC. The staff understands that advisers typically used this information to identify important regulatory issues and potential control weaknesses at the managers.

iii. Advisers Are Performing Additional Quantitative Analyses and Risk Measures on the Alternative Investments and Their Managers

- *Detection of Manipulation of Performance Returns.* As compared to the staff's observations in earlier time periods, the staff observed that advisers were increasing the use of quantitative analysis in an attempt to detect aberrations in investment returns. This measure is intended to identify managers that have falsified or otherwise manipulated their returns. Advisers confirmed their increased use of these measures, which typically included: (i) bias ratio; (ii) serial correlation; and (iii) "skewness" of the return distribution. These measures also were analyzed in conjunction with factor analysis of the returns in order to detect suspect returns that may be an indication of manipulation.

- *Supplementation of Investment-Level Decision-Making.* The staff observed that advisers have increased their use of quantitative risk measures to supplement investment-level decision-making processes. The risk measurements supplemented the investment due diligence process (*e.g.*, through measures such as factor analysis to provide an indication as to how closely a manager was implementing the stated strategic approach). The staff also observed that some advisers' risk teams used sophisticated quantitative measures to identify potential problems before those problems would manifest in performance returns or adverse reports from the manager.

iv. Advisers Are Enhancing and Expanding Their Due Diligence Processes and Focus Areas

- *Operational Due Diligence Focus*. The staff observed that although many advisers have always had a focus on operational due diligence, some advisers have increased their efforts in this critical area and other advisers established operational due diligence groups.[11] For example, the staff found that many advisers had experienced, dedicated operational teams with the ability to veto any alternative investment manager candidate that did not satisfy a team's review. Among other things, this review may include evaluation of the manager's policies and procedures regarding valuation.

- *Legal Documents Review*. The staff observed that most advisers included a review of legal documents as part of their due diligence process. In addition, the staff observed that some advisers focused greater attention on legal reviews in an effort to detect legal document risk. Document risk may include unique contractual provisions or preclusions that present unique risks to investors, such as the inability of an investor to liquidate its investment upon certain events in the alternative investment fund. Legal analysis, which was generally conducted by

[11] Operational Due Diligence generally focuses on non-investment risk such as business operations risk and its associated control environment, including controls related to managing conflicts.

the adviser's legal staff, may include the review of offering materials, side letters, subscription agreements, and counterparty agreements.

- *Investment Fund Redemption Terms and Liquidity of the Portfolio*. The staff observed that advisers' due diligence teams tended to focus closely on liquidity issues. The staff was informed that this increased attention was likely attributed to managers imposing redemption restrictions on investors during the financial crisis. Specifically, advisers generally assessed the appropriateness of redemption terms in light of the underlying portfolio composition to identify significant mismatches in liquidity. In particular, advisers to alternative investments that invest in other alternative investments appeared to be more sensitive to the liquidity terms of the underlying managers' portfolios to ensure that they corresponded with the liquidity terms of their own alternative investments.

- *Onsite Visit Requirement*. The staff observed that most advisers included onsite visits to managers as part of their investment, risk management, and operational due diligence reviews. Advisers also informed the staff that onsite visits helped due diligence teams: (i) understand the culture of the manager; (ii) detect instances where dominant individuals and inadequate control environments may exist; (iii) and provide increased access to review documents and to speak with the manager's personnel.

- *Audited Financial Statements Review*. The staff observed that, although many advisers have previously received and reviewed the audited financial statements of private alternative investments, some advisers have recently expanded their review of such records. For example, some advisers were reviewing the audited financial statements, among other sources, to identify possible related party transactions and to identify valuation concerns.

B. Warning Indicators or Awareness Signals for Concern For Advisers

Advisers utilizing some or all of the due diligence methods noted above did so in an attempt to identify certain risk indicators during their investment, operational, and risk management reviews. Some of these indicators, which are noted below, led advisers to conduct additional due diligence analysis, to request that the manager make appropriate changes, or to reject (or veto) the manager or the alternative investment.[12]

i. Investment

- Managers that were unwilling to provide requisite transparency regarding portfolio holdings to the adviser;
- Performance returns that did not correlate with known factors associated with the manager's strategy, as described by the manager;
- Lack of clear research and investment processes; and
- Lack of an adequate control environment and segregation of duties between investment activities and business unit controllers (*e.g.*, managers dominating the valuation process).

[12] Staff has observed that, while firms typically have dedicated groups in the areas specified in this section, these groups usually work in close conjunction and have some degree of overlap.

ii. Risk Management

- Alternative investment portfolio holdings that showed a high concentration in a single investment position, or a heavy concentration in a single sector, for a purportedly diversified investment strategy;
- Manager personnel that appeared to be insufficiently knowledgeable about a sophisticated strategy they were purportedly implementing;
- Manager investment style that appeared to have drifted over time; and
- Investments, as described by the manager, that appeared to be overly complex or opaque.

iii. Operational

- Lack of a third-party administrator or an unknown/unqualified administrator;
- Use of an auditor that may not have significant experience auditing private investment funds or is an unknown auditor;
- Multiple changes in key service providers, such as auditors, prime brokers, or administrators;
- Concerns identified in audited financial statements such as qualified opinions, related party transactions, or valuation concerns;
- Background checks that revealed unfavorable regulatory history, bankruptcy filings, or serious legal issues of the manager or key personnel;
- Identification of undisclosed potential conflicts of interests, such as compensation arrangements or business activities with affiliates;
- Insufficient operational infrastructure, including an inadequate compliance program; and
- Lack of a robust fair valuation process.

II. Staff Observations – Compliance With the Advisers Act

During its examinations, in addition to collecting the information about current practices described above, the staff also assessed advisers' compliance with applicable laws, rules and regulations.

A. Compliance Programs

Advisers are required by Rule 206(4)-7 under the Advisers Act to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and to annually review the adequacy of those policies and procedures and the effectiveness of their implementation. These requirements include: (i) naming a Chief Compliance Officer ("CCO") to administer their programs; (ii) adopting compliance policies and procedures; and (iii) completing annual reviews of the effectiveness of their compliance policies and procedures. Additionally, while typically not incorporated into the advisers' compliance manuals, many of the advisers examined by the staff had written, formal due diligence policies and procedures or guidance in place; those that did not had, at a minimum, some type of informal due diligence framework in place. Below are some areas where material deficiencies or control weaknesses were observed in some of the examinations.

- *Annual Review*. The staff observed that some advisers, for whom investing in or recommending alternative investments was a key portion of their business, did not include in their annual review a review of their due diligence policies and procedures for such investments.

- *Disclosures Made to Clients***.** The staff observed that advisers' disclosures sometimes deviated from actual practices, and that advisers with material deficiencies in their disclosures failed to review disclosures for consistency with fiduciary principles or to describe notable exceptions made to the adviser's typical due diligence process.

- *Marketing Claims***.** The staff observed that some advisers' marketing materials contained information about the scope and depth of the due diligence process that could be misleading or statements that appeared to be unsubstantiated. For example, one adviser overstated the number of research analysts and their average years of experience in the industry.

In addition to material deficiencies, the staff also made the following observations:

- *Policies and Procedures*. The staff observed that advisers were more likely to have due diligence processes that were consistently applied if they adopted written policies and procedures that were detailed and required adequate documentation. These advisers incorporated compliance oversight into their business and operations and were able to use these policies as an internal guide in the selection and monitoring of portfolio investments and their related third-party managers.

- *Oversight of Service Providers.* The staff observed that in some instances, advisers delegated certain responsibilities to third-party service providers. Advisers that did not conduct periodic reviews of their service providers to determine whether the service providers were abiding by the terms of their agreements were more likely to have deficiencies in meeting those responsibilities.

B. Code of Ethics

All advisers registered with the SEC must adopt and enforce a written code of ethics reflecting the adviser's fiduciary duties to its clients.[13] At a minimum, such codes should set forth the minimum standard of conduct for all "supervised persons" (*i.e.*, employees, officers, directors, and other persons that the adviser is required to supervise) and must address personal securities trading by these persons. The code of ethics that each adviser chooses to adopt and implement should reflect its fiduciary obligations to its clients and the fiduciary obligations of the persons under its supervision, and require compliance with the federal securities laws.

- *Limited offering review*. The staff observed instances in which advisers invested in or recommended a limited offering to their clients, while they also permitted access persons to acquire an interest in that same limited offering but with preferential investment terms (*i.e.*,

[13] Advisers Act Rule 204A-1.

greater liquidity or reduced fees). Such arrangements create a conflict of interest that may influence the adviser's due diligence process to the detriment of clients — the advisory employee receiving the preferential terms may be incentivized by their own financial interests rather than the best interest of advisory clients. Furthermore, the staff identified instances where advisers did not maintain a record of any decision, and the reason supporting the decision, to approve the acquisition of securities by access persons, as required by Rule 204-2(a)(13)(iii).

III. Conclusion

The staff hopes that this overview of examinations concerning the due diligence practices of advisers will help to support the compliance programs of registrants.

If you suspect or observe activity that may violate the federal securities laws or otherwise result in harm to investors, please notify us at: http://www.sec.gov/complaint/info_tipscomplaint.shtml.

This Risk Alert is intended to highlight for firms risks and issues that the staff has identified in the course of examinations regarding investment adviser due diligence processes for selecting alternative investments and alternative investment managers. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance, and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.