Client Alert

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SEC Staff Offers Roadmap for Alternative Investment Due Diligence Processes

By Kelley A. Howes

The SEC believes that investment advisers, including pension consultants, are increasingly recommending that their clients invest a portion of their portfolios in private alternative investment funds. In light of that trend, the SEC's OCIE National Exam Program (NEP) staff recently published a Risk Alert addressing due diligence processes related to selecting alternative investments and their managers.

The OCIE staff recognizes that due diligence of alternative investments can be more challenging in light of the characteristics and complexity of certain alternative strategies. The Risk Alert sheds some light on the staff's views of "best practices" for such due diligence and related compliance programs. Investment advisers might also glean some insight into the examination staff's focus in upcoming visits.

TRENDS

The NEP staff identified trends in due diligence practices used by investment advisers recommending alternative investments. These include:

- *Increasing requests for position level transparency*. Investment advisers frequently require this level of transparency in order to execute their risk assessment policies. According to the staff, managers of alternative investments are often reluctant to provide the information due to concerns that it would compromise their ability to execute their strategies, and so the level of transparency obtained by advisers is generally a matter of negotiation between the parties.

- *Separate account management*. Many advisers recommend pooled investment vehicles due to the relatively lower expenses, higher operational efficiency and decreased opportunity for inequitable treatment of investors. The staff observed, however, that some investment advisers increasingly recommend that clients invest in alternative investments through separate accounts. This structure addresses the transparency concerns noted above, since separate account holders have full transparency into their holdings. In addition, a separate account mandate can decrease the opportunity for misappropriation of client assets and allows the investment adviser to more closely monitor the account's liquidity and valuation.

- *Increased use of information aggregators*. Investment advisers are also obtaining transparency into account holdings through the use of information aggregators, which receive portfolio-level information from private alternative investment funds and aggregate that information for transmission to investment advisers conducting due diligence reviews. Aggregate information allows advisers to make broad assessments of the risks of particular alternative investments while at the same time enables the alternative investment managers to avoid disclosing proprietary information.

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- *Use of other third-party service providers*. The staff observed that many advisers rely on administrators, custodians and auditors to independently verify alternative investments. The staff also said that if private alternative investment funds did not have an independent third-party administrator, some investment advisers will not recommend that their clients invest in those funds. According to the Risk Alert, certain investment advisers believe that use of third-party administrators may mitigate risks such as the misappropriation of investor assets and it ensures segregation of duties. In addition, third-party administrators are issuing transparency reports that include details about the alternative investment funds' (i) net asset value; (ii) custodian; (iii) percentage of investment priced by the third party administrator; and (iv) assets and liabilities measured at "fair value" under FASB ASC 820, Fair Value Measurements.

- *Background checks.* The NEP staff observed that investment advisers retain third-party firms to conduct comprehensive background checks on alternative investment managers and their key personnel. In addition, some investment advisers use publicly available information (e.g., FINRA's BrokerCheck and the SEC's Investment Adviser Public Disclosure website) to conduct additional background checks. Investment advisers are also increasingly requiring that alternative managers provide copies of any examination-related letters from the SEC.

- *Quantitative analytics*. The staff said that investment advisers increasingly use quantitative analysis to attempt to detect aberrational performance. According to staff, the preferred analytics include (i) bias ratio; (ii) serial correlation; and (iii) "skewness" of the return distributions. The staff also observed that advisers are using quantitative risk measures in connection with their investment-level decision making.

- *Operations and legal reviews*. Although investment advisers have always focused on operational and legal due diligence, it appears that some advisers have enhanced their focus in these areas. Thus, advisers are increasingly likely to staff their due diligence teams with experienced operations professionals. In addition, legal document reviews focus not just on contracts between the parties, but also includes offering materials, side letters, subscription agreements and counterparty agreements. Onsite visits continue to be a critical part of this due diligence.

- *Focus on liquidity*. The staff observed that, in part due to redemption restrictions imposed by certain alternative investment managers during the financial crisis, investment advisers increasingly focus on liquidity of alternative investments. This focus generally manifests itself in attention to the appropriateness of redemption terms. In the case of a fund that invests in underlying private alternative investment funds, this includes ensuring that the liquidity terms of the underlying private alternative investment fund are consistent with those of the fund managed by the investment adviser.

WARNING SIGNS

According to the Risk Alert, particular risk indicators can cause investment advisers to: (i) conduct additional due diligence; (ii) require that an alternative investment manager make certain changes; or (iii) veto an investment with that manager. The warning signs included:

- reluctance by alternative investment managers to provide transparency into portfolio holdings;

- performance that does not correlate to known factors related to the manager's strategy;

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- lack of clear research and investment processes;
- lack of adequate controls or segregation between investment and business units (e.g., portfolio managers dominating a valuation decision);
- high concentrations in a single investment or sector in a purportedly diversified strategy;
- personnel with insufficient knowledge about sophisticated strategies;
- portfolio style drift;
- overly complex or opaque descriptions of investments;
- failure to use a third-party administrator or use of an unknown administrator;
- use of an auditor without sufficient experience in auditing private investment funds;
- multiple changes in service providers (e.g., auditors, prime brokers or administrators);
- concerns about the financial statements, including qualified audit opinions, related party transactions or valuation issues;
- unfavorable regulatory or other legal issues related to the manager or its key personnel;
- identification of undisclosed conflicts of interest (e.g., compensation arrangements or business activities);
- insufficient operations infrastructure; and
- lack of a robust fair valuation process.

COMPLIANCE BEST PRACTICES

The staff reported on several compliance best practices in addition to those discussed above that investment advisers should consider adopting when reviewing their own alternative investments due diligence programs. These include:

- *Implement a written due diligence protocol.* These programs need not be integrated with the compliance program required by Rule 206(4)-7 under the Investment Advisers Act. They should, however, be (i) reviewed annually; (ii) consistent with the disclosures provided to clients (and such disclosures should reflect the adviser's fiduciary responsibility to their clients); and (iii) consistent with representations made in client marketing materials.
- *Adequate oversight of service providers*. To the extent that investment advisers delegate due diligence responsibilities to service providers, they should periodically review those service providers to ensure compliance with written agreements.
- *Code of ethics*. The staff raised concerns about advisers' codes of ethics that permit access persons to acquire interests in recommended limited offerings on terms that are preferential to the adviser's clients (e.g., with reduced fees or greater liquidity). The staff noted that this can create conflicts of interests that could influence the due diligence process to the detriment of clients. The staff also observed that advisers are required by Rule 204-2(a)(13)(iii) under the Advisers Act to document the reasons for allowing an access person to acquire such securities.

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CONCLUSION

Investment advisers that recommend alternative investments to their clients should review the practices and concerns identified in the Risk Alert against their due diligence programs. At a minimum, we recommend that investment advisers ensure that their due diligence programs:

- are adequately documented and periodically reviewed;
- focus on identifying, disclosing and mitigating conflicts of interest; and
- to the extent possible, make use of experienced investment teams to evaluate complex investment strategies and fund structures.

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