FS Regulatory Brief

SEC Sweep Examination of Due Diligence processes for Alternative Investments

In August 2010, the SEC sent notice letters to certain fund of funds announcing an examination focused on the due diligence processes employed when advisers evaluate alternative investment options. For purposes of the review "alternative investment" includes private equity, venture capital, fund of funds and hedge funds. The letters were sent from the SEC's Office of Compliance Inspections and Examinations in Washington, DC. The SEC staff is requesting general information (organizational information, litigation, joint ventures, Form ADV Part II, compliance policies and procedures), as well as information and processes specifically related to due diligence of alternative investments.

The SEC's letter states that examiners may wish to speak with various employees of the Adviser including, but not limited to, the Chief Compliance Officer, middle and back office personnel responsible for performing research on underlying investments, any person responsible for making decisions on the research information and the Head of the Registrant's Investment Committee.

Due Diligence Processes

SEC staff has asked for policies and procedures surrounding vetting prospective investments and the periodic review of investments held. In addition, they have asked for a list of staff that participates in the due diligence process as well as any third parties upon which the Adviser relies in connection with this process. SEC staff will also review due diligence files for notes about redeemed investments or prospective investments that were rejected and the rationale behind those decisions. The SEC has requested that the Advisers provide written questionnaires, a sample due diligence report, materials used to train staff on these processes, and a description of quality control and forensic tests performed in connection with due diligence.

The letter requests that the Registrant provide the rationale for any alternative investments that were removed from the portfolio during the exam period. The letter specifically asks that Registrant include divestitures resulting from a decrease in the transparency that was originally agreed upon.

Privately Offered Funds

The SEC will also be taking a detailed look at the private investments that the Registrant, an affiliate or any related person has formed, managed or in which they have an interest. Requested information includes investor details, the amount of interest of Registrant and affiliated persons, financial information as well as redemptions during the examination period. Registrants are also required to provide copies of any side letters associated with any such investments and information regarding any complaints received from clients, shareholders or investors.

Marketing

The SEC has requested a copy of all marketing materials furnished to existing and prospective investors, completed RFPs, and the names of any third-party consultants for which Registrant responded to questionnaires.

Points to Consider

- The SEC will consider whether Advisers are properly supervising investor money by delving into due diligence processes. Advisers should consider whether the standards performed and documented are in line with what has been represented to investors. Policies must be robust and employees involved in the decision making process should be sufficiently trained. The SEC will look at quality control and sufficiency of forensic tests performed.
- Advisers should ensure that they are not overly reliant upon information provided by underlying managers and that they are performing their own research to verify such information. The Adviser should have sufficient checks and balances in place so that a single employee does not have the ability to approve a new investment.
- It is important to note that the SEC will also be reviewing investments that were redeemed or rejected and the rationale behind these decisions. Advisers should ensure that these decisions are properly documented. Underlying managers should be aware of the potential source of information for the SEC contained in the due diligence files of the fund of funds on investments redeemed or rejected which could serve as a blueprint for further investigation of the underlying manager.
- Advisers should review Policies surrounding Conflicts of Interest to ensure that they address potential conflicts associated with channeling money into alternative investments. Advisers should consider conflicts of interest between the fund of funds and the underlying fund managers as well as any fee splitting or revenue sharing arrangements that are in place with consultants or outside advisers that help with investment selection. Generally, how is the Adviser getting comfortable with the fact that outside parties are unbiased when considering initial and ongoing investments?
- If Advisers permit employees to make direct investments into alternative investments, they should consider whether employees have an advantage over investors due to greater transparency. Advisers should undertake a detailed review of their personal trading policies, with a focus on safeguards against front-running to ensure that employees are not using transparency for personal gain.
- Advisers should review marketing practices for consideration of underlying composite track records and accompanying disclosure challenges. In addition, Advisers should ensure that materials include the proper disclosures with regard to investing in alternatives and any related fee layers associated with this type of investment.

Additional Information

If you would like additional information about the topic discussed in this FS Regulatory Brief or a redacted copy of the SEC's letter, please call:

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