
The Scope of the Staff’s Observations: The Risk Alert indicated that the Staff’s observations were based on more than 10 examinations of SEC-registered investment advisers to pension plans and funds of private funds. The Staff noted that it did not examine commodity pools or registered investment companies. Also, the Risk Alert did not address the due diligence practices of advisers directly managing alternative investments. Rather, it focused on advisers selecting those underlying managers. Thus, in light of the limitations on the Risk Alert’s scope, it should be seen as applying to a specialized market segment: advisers making discretionary investments in alternative products managed by other advisers.

Due Diligence Practices: The Risk Alert described several due diligence practices observed by the Staff. Importantly, it indicated that the Staff does not state any view on the effectiveness or ineffectiveness of the observed practices. Rather, the Risk Alert noted that the adequacy of any practice can only be determined with reference to the profile of the specific firm and other facts and circumstances. Nonetheless, the practices listed by the Staff should be of interest to any adviser who invests in alternative products managed by other advisers. These practices include several types:

Transparency: The Risk Alert stated that advisers are seeking greater transparency from the managers of underlying alternative investments. These practices include requesting information on specific positions in the underlying portfolio and recommending that client assets be managed in separate accounts to provide greater individual transparency and control.

Utilization of Third Parties: The Risk Alert stated that advisers are increasingly utilizing third parties in a number of ways. Advisers are using portfolio information aggregators, and they are seeking to verify information about underlying managers from third party service providers such as administrators, custodians and auditors. They are limiting investments to alternative investments with independent administrators and are requesting independent “transparency reports” from third-party administrators. They are conducting background checks on managers and key personnel. Finally, advisers are using public data sources like FINRA’s BrokerCheck to review the regulatory histories of persons involved in managing the alternative investment.

Quantitative Analyses: The Risk Alert stated that advisers are using more quantitative analysis to detect aberrations in investment returns, including bias ratios, serial correlations and the “skewness” of return distribution. They also are using a factor analysis to indicate how closely the underlying manager was implementing a stated strategy. Finally, some advisers are using sophisticated quantitative measures to foresee potential problems before they manifest in performance or adverse manager reports.

Expanded Processes: The Risk Alert also identified several areas in which advisers have expanded the scope of their due diligence. These new practices include enhanced focus on operational due diligence, including dedicated operational teams with the ability to veto an investment; review of legal documents for risky provisions or preclusions; attention to liquidity issues such as the match between redemption terms and the composition of the portfolio; onsite visits; and review of audited financial statements.

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**Warning Indicators:** The Risk Alert noted several observed risk indicators that could lead an adviser to conduct additional due diligence, request the underlying manager to make appropriate changes, or reject or veto the investment. Advisers can assume that SEC Staff will ask about these risks in future adviser examinations. As a result, they warrant careful attention. The risk indicators are:

- Managers are unwilling to provide transparency regarding the underlying portfolio;
- Performance returns did not correlate with the manager’s stated strategy;
- There is a lack of a clear research and investment process at the manager level;
- There is a lack of adequate controls and segregation of duties, such as when managers dominate valuation;
- Supposedly diversified portfolios show heavy concentrations;
- Manager personnel appear insufficiently knowledgeable about their own strategies;
- Manager’s style appears to have drifted over time;
- Investments appear overly complex or opaque;
- There is a lack of a third-party administrator, or the administrator is unknown or unqualified;
- The auditor is unknown or does not appear to have significant relevant experience;
- There have been multiple changes in key service providers;
- The financial statements have a qualified opinion, related party transactions or valuation concerns;
- Background checks reveal an unfavorable regulatory history, bankruptcy filings or serious legal issues;
- Manager has undisclosed potential conflicts of interests, such as compensation arrangements or business activities with affiliates;
- There is an insufficient operational infrastructure, including an inadequate compliance program; and
- There is a lack of a robust fair valuation process.

**Compliance Practices:** Finally, the Risk Alert discussed compliance practices identified by the SEC Staff. As a positive practice, the Staff noted that advisers with detailed due diligence policies and procedures that require adequate documentation were more likely to have consistent processes that incorporate compliance oversight and guide business operations. However, the Risk Alert also noted several practices that appear less than positive:

- The adviser’s annual review pursuant to Rule 206(4)-7 did not include a review of the adviser’s due diligence policies and procedures for alternative investments when these investments
were a key portion of the adviser’s business;

• Disclosures to clients deviated from the adviser’s actual practices;

• Marketing materials contained information about the adviser’s due diligence practices that could not be substantiated;

• The adviser did not conduct periodic reviews of due diligence service providers to ensure that they are complying with the terms of agreements; and

• The adviser gave access persons preferential investment terms or failed to document the decision to approve the access person’s acquisition of alternative investments also being placed in client accounts.

Conclusion: While the scope of the Risk Alert is limited to a specialized sector of the adviser community, it provides interesting insight into the thinking of the SEC Staff in this important area. The practices observed by the Staff provide an interesting benchmark for advisers to consider, and the warning indicators and compliance failures provide food for thought.


If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed or the Sutherland attorney with whom you regularly work.